Fourth Annual Institute on Municipal Finance Law

Robert S. Amdursky
Chairman

Practising Law Institute

REAL ESTATE LAW AND PRACTICE
Course Handbook Series
Number 263

Institute on Municipal Finance Law

Fourth Annual Institute on Municipal Finance Law

Robert S. Amdursky
Chairman

N4-4442
Practising Law Institute

Library of Congress Catalog Card Number: 82-61183

FOREWORD

This course handbook is one of about 150 published each year by the Practising Law Institute.

Its primary function is to serve as an educational supplement to each program. It may also be used as a reference manual by attorneys and related professionals unable to attend the sessions.

The method of reproduction utilized has been chosen to insure that registrants receive these materials as quickly as possible in the most usable form practicable.

The Practising Law Institute wishes to acknowledge its debt and extend its sincere appreciation to the authors who have rendered this valuable service. They exemplify the finest tradition of our profession by sharing their expertise with their colleagues.

4

Prepared for distribution at the
FOURTH ANNUAL INSTITUTE ON
MUNICIPAL FINANCE LAW
September 12-13, 1985
New York City

CONTENTS

LG

1

THE APPLICATION OF THE FEDERAL SECURITIES LAWS TO THE ISSUANCE AND SALE OF MUNICIPAL SECURITIES

David G. Ormsby

August 19, 1985

The Application of the Federal Securities Laws to the Issuance and Sale of Municipal Securities

I. STATUTORY FRAMEWORK

1. Section 5 of the Securities Act of 1933 (the "1933 Act") requires that a registration statement be in effect in order to utilize the facilities of interstate commerce in the sale of any security unless the security is of a class exempted by Section 3 of the 1933 Act or is offered in a transaction exempted by Section 4 of the 1933 Act. Section 12(1) of the 33 Act permits an investor to recover his purchase price (or damages if the security has been sold) from the issuer if a security has been sold without registration in violation of Section 5. A principal class exemption is contained in Section 3(a)(2) of the 1933 Act which, in general, exempts any municipal security and certain industrial development bonds from the registration requirements of the 1933 Act. Section 3(a)(2) is annexed as Exhibit A.

   (a) The legislative history of the 1933 Act suggests four historical bases for the Section 3(a)(2) exemption:

      (i) absence of abusive sales practices;

      (ii) institutional nature of most municipal investors;

      (iii) constitutional issue raised by the application of Federal law to municipal issuers; and

      (iv) effect on essential government services.

2. Industrial Development Bonds--the relationship between tax exemption afforded by Section 103(b) of the Internal Revenue Code and the Section 3(a)(2) exemption is critical. SEC Release No. 33-5103 (November 6, 1982.) See, e.g., SEC v. Haswell [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 97,156, where the plaintiff unsuccessfully argued that the failure to use substantially all bond proceeds to purchase land or depreciable property resulted in a failure to satisfy the small-issue IDB exemption of the Internal Revenue Code and, thus, also forfeited the exemption from registration under the 1933 Act.

3. The definition of "security" contained in Section 2(1) of the 1933 Act includes a ". . . guaranty of . . ." a security. Where the basic security is exempt from the registration requirements of the 1933 Act by reason of Section 3(a)(2), will a guarantee of that security also be exempt? Not necessarily.

   (a) Rule 131 of the SEC's 1933 Act General Rules and Regulations annexed as Exhibit B.

   (b) In its "no-action" policies, the SEC has generally required sufficient identity between obligor and guarantor to assure that a single investment decision is made.

      (i) The guarantee by a parent corporation of its wholly-owned subsidiary's obligation will be regarded as exempt. Industrial Development Authority of the City of Chesapeake (available August 7, 1978); Manhattan Health Authority, Inc. (available June 27, 1977); See also Genuine Parts Company (available December 30, 1977) (guarantee by

59.8% stockholder); Industrial Development Board of City of Mount Pleasant, Tennessee (available December 15, 1975) (guarantee by 50% stockholder); County of Montgomery, Ohio (available by October 10, 1974) (guarantee by 50% stockholder); but cf. denial of exemption where bonds were to be guaranteed by a vendor to the lessee of a manufacturing facility to be constructed from bond proceeds. County of Muskingum (available April 11, 1974).

(ii) the joint and several guarantee of bonds issued on behalf of a partnership by the general partners of the partnership was exempt. Barnwell County, South Carolina (available July 4, 1974). See also The County Commission of Kanaha County (available September 14, 1981) where the bonds were guaranteed by (i) the 60% general partner, (ii) the 40% general partner and (iii) the parent of the 40% partner, of the lessee partnership; Industrial Development Authority of the City of Hopewell, Virginia (available November 5, 1976) where the bonds were personally guaranteed by two individual limited partners of the partnership obligor in two-thirds, one-third proportions.

(iii) the guarantee by indiyiduals who were sole stockholders of the lessee corporation was exempt. Richmond County Health Corporation, Inc. (available May 16, 1977). See

also Calhoun County Medical Facilities, Inc. (available December 3, 1973) where seven individual guarantors were each an officer, director, stockholder or interested party in the primary obligor. But cf. denials of exemption where guarantee was by "principals, but not shareholders" of the primary obligor, Marshall County, Kentucky (available September 26, 1977) and by local farmers and ranchers of a county's bonds to be issued to finance a packaging facility. The County of Yellowstone (available August 16, 1976).

(iv) Cf., however, Woods v. Homes and Structures of Pittsburgh, Kansas, Inc. 489 F. Supp. 1270 (D. Kan. 1980), in which the SEC's failure to issue no-action letters in the case of non-user guarantees was regarded as unpersuasive. The District Court noted that the guarantee in question was not sold separately from the bonds and found no statutory requirement or public policy for treating it differently than the exempt-bond issue.

(c) Note that ". . . any security issued or guaranteed by any bank" will also be exempt from registration under Section 3(a)(2) of the 1933 Act. Thus, a letter of credit effectively guaranteeing the payment of principal and interest on a municipal obligation will typically be exempt. The Great Atlantic & Pacific Tea Company, Inc. (available July 2, 1981); San Marcos County Water District Assessment Bonds (available January 11, 1979). Notwithstanding the

definition of "bank" in Section 3(a)(2) limiting the term to a national bank or banking institution organized under the laws of any state, territory or the District of Columbia, the SEC has issued no-action letters confirming exemptions for letters of credit issued by U.S. branches or agencies of foreign banks. The Fuji Bank Limited (available October 15, 1979); Toronto Dominion Bank (available November 30, 1981); The Mitsubishi Bank, Ltd., Los Angeles Agency (available August 17, 1984). But cf. the SEC's denial of exemption where the obligation of a bank to purchase municipal bonds in the event of default was that of a foreign bank directly. The Industrial Development Board of Huntsville, Alabama (available September 27, 1974).

(d) Note further that Section 3(a)(8) also provides an exemption from the Act for ". . . any insurance . . . contract issued by a corporation subject to the supervision of the insurance commissioner of any State . . . of the United States." See Texas Housing Agency Residential Development revenue Bonds, Series 1983 A (available May 19, 1983); American Municipal Bond Assurance Corporation (available July 17, 1972). Woods v. Homes and Structures of Pittsburgh, Kansas, Inc., 489 F. Supp. 1270 (D. Kan. 1980).

(e) Where no exemption is available, the guarantee may be registered under the 1933 Act. See, e.g., the Official Statement and Prospectus dated November 12, 1982, reflecting registration of a Letter of Credit issued by General Electric Credit Corporation annexed as Exhibit C.

(f) The Integration Doctrine

(i) Will a contemporaneous public offering under Section 3(a)(2) forfeit the availability of the private placement exemption of Section 4(2) or Regulation D? Probably not. Polk County Industrial Development Authority (available December 26, 1975); Buckeye International Inc. (available March 7, 1977). See also Biogen, N.V. (available July 20, 1981).

4. For an issuer to avoid civil liability under Section 12 for the unregistered sale of a municipal security it must be exempt under Section 3(a)(2). Accordingly, if an industrial development bond does not satisfy the requirements of Section 103(b) of the Internal Revenue Code, it will not satisfy Section 3(a)(2) and civil liability under Section 12 may arise for any person who offers or sells such a security.

5. Section 17(a) prohibits the use of fraudulent or deceptive acts in connection with the offer or sale of any security.

6. Section 20(b) authorizes the SEC to seek injunctive relief when it appears that a person is engaged or is about to engage in a violation of the 1933 Act.

7. Section 24 imposes criminal penalties for a wilful violation of the 1933 Act or rules promulgated thereunder.

B. Securities Exchange Act of 1934

1. The Securities Exchange Act of 1934 (the "1934 Act") requires registration of every issuer of securities listed on a national exchange or held by more than 500 persons and the filing of periodic

reports with the SEC. Section 3(a)(12) exempts from the 1934 Act ". . . municipal securities, as defined in Section 3(a)(29) of this title". In turn, Section 3(a)(29) contains a definition roughly coextensive with Section 3(a)(2) of the 1933 Act. Section 3(a)(29) is annexed as Exhibit D.

2. Section 10 and Rule 10b-5.

   (a) An implied private right of action exists in favor of purchasers of municipal securities. Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971) (seller of U.S. Treasury Bonds); In re New York Municipal Securities Litigation, 507 F. Supp. 169 (S.D.N.Y. 1980) (purchasers of obligations of New York City).

   (b) A private cause of action for damages under Rule 10b-5 will not lie absent proof of scienter. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

   (c) Reckless conduct has generally been held sufficient to satisfy the scienter requirement. ITT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980); Mansbach v. Perscott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979); Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38 (2d Cir. 1978), cert. denied 439 U.S. 1039 (1978); Hoffman v. Estabrook & Co., Inc., 587 F.2d 509 (1st Cir. 1978).

3. Section 15B.

   (a) Municipal Securities Rulemaking Board. The Securities Acts Amendments of 1975 established the MSRB with responsibility for developing a system of registration and regulation for dealers engaged in

underwriting and trading municipal securities, as well as rules governing professional qualifications, record keeping, quotations and advertising. Note that the MSRB has rulemaking authority only. Responsibility for ensuring compliance with MSRB rules rests primarily with bank regulators for dealer banks and the NASD for registered broker-dealers.

(b) The Tower Amendment--
Section 15B(d):

The legislative history of clauses (d)(1) and (2) of Section 15B indicates that the amendments "were designed to make it clear that [they] will not be a means of subjecting states, cities, counties or villages to any unnecessary disclosure requirements promulgated by the [Municipal Securities Rulemaking Board]". 121 Cong. Rec. 10737, 94th Cong., 1st Sess. (1975) (Remarks of Senator Tower). Cf. H.R. 2032; S. 936

(c) MSRB Rule G-32 requires municipal securities dealers that sell new issues of securities to provide their customers with any Official Statement which has been voluntarily provided by the issuer.

4. Section 21(d) authorizes the SEC to seek injunctive relief when it appears that a person is engaged or about to engage in a violation of the 1934 Act.

5. Section 32(a) imposes criminal penalties for a wilful violation of the 1934 Act or rules promulgated thereunder.

C. Trust Indenture Act of 1939

1. The Trust Indenture Act requires any mortgage, deed of trust, indenture,

trust or similar instrument or agreement governing the public issuance of more than $1,000,000 of securities to be qualified with the SEC. However, Section 304(a)(4) exempts any security which is exempt from the provisions of the 1933 Act by Section 3(a)(2) thereof.

(a) SEC Release No. T1-284 (November 6, 1970).

(b) The anti-fraud provisions of Sections 323 and 324.

D. The Role of the Securities and Exchange Commission

1. Rule 2(e) of the Rules of Practice.

(a) The Disciplinary Proceeding.

Rule 2(e) permits the SEC to suspend and disbar from Commission practice any person found after notice and an opportunity for hearing (i) not to possess the requisite qualifications to represent others, or (ii) to be lacking in character or to have engaged in unethical or improper professional conduct, or (iii) to have wilfully violated, or wilfully aided and abetted the violation of, any provision of the Federal securities laws or the rules and regulations thereunder. The SEC may temporarily suspend without a hearing any attorney, accountant, engineer or other professional who has been permanently enjoined by a court in an action commenced by the Commission, or has been found by a court or the Commission to have violated, or aided and abetted a violation of, the Federal securities laws. Such a temporary suspension becomes permanent unless the person so suspended petitions the SEC within 30 days after

service of the order to lift the suspension.

(b) The Consent Decree.

Securities and Exchange Commission v. Calhoun County Medical Facility, Inc., et al., No. 81-66 (N.D. Miss.) (May 19, 1981) annexed as Exhibit E; In re Jo M. Ferguson, SEC Release No. 33-5523 (August 21, 1974) annexed as Exhibit F.

2. Section 21(a) of the Securities Exchange Act of 1934.

(a) The Private Investigation and Report.

(i) SEC Staff Report, Transactions in the Marine Protein Corporation Industrial Development Revenue Bonds, SEC Release No. 34-15719 (April 11, 1979).

(ii) SEC Staff Report, Transactions in Securities of the City of New York (August 26, 1977); SEC Final Report, In the Matter of Transactions in the Securities of the City of New York (February 5, 1979).

Note that a "preliminary" investigation by the SEC requesting information concerning the financial affairs of a city does not constitute an impermissible intrusion into state sovereignty. City of Philadelphia v. SEC, 434 F. Supp. 281 (E.D. Pa. 1977), appeal denied, City of Philadelphia v. SEC, 434 U.S. 1003 (1978).

(iii) SEC Staff Report cited at Paragraph II A 3(d) below.

3. The Injunctive Action.

(a) SEC v. Reclamation District No. 2090, Litigation Release No. 7460 (June 22, 1976); SEC Litigation Release No. 7647 (September 2, 1976); SEC v. Astro Products of Kansas, Inc., SEC Litigation Release No. 7557 (September 13, 1976); SEC Litigation Release No. 7774 (February 10, 1977).

(b) The SEC will be required to establish scienter as an element of a civil enforcement action to enjoin violations of Section 10(b) of the Exchange Act and Section 17(a)(1) (but not 17(a)(2) or 17(a)(3)) of the Securities Act. Aaron v. SEC, 100 S. Ct. 1945 (1980).

4. Registration and Regulation of Brokers and Dealers Section 15(b) of the Exchange Act).

(a) In re Bache Halsey Stuart, Inc., SEC Release No. 34-12847 (October 1, 1976).

5. The "no-action" letter.

II. THE JUDICIAL GLOSS

A. The Public Offering of Municipal Securities

1. The function of the Official Statement.

(a) A sale of securities must be accompanied by a full disclosure of all facts which a reasonable investor might consider important in the making of an investment decision. Affiliated UTE Citizens v. United States, 406

U.S. 128 (1972). Cf. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976), in which the Supreme Court stated that an omitted fact is material if there is substantial likelihood that a reasonable investor would consider it important in reaching a decision.

(b) "A municipality's official statement is central to any system designed to facilitate full disclosure." SEC Final Report In the Matter of Transactions in the Securities of the City of New York, supra, p. 53.

2. The Underwriters' responsibilities.

(a) "It is incumbent on firms participating in an offering and on dealers recommending municipal bonds . . . to make diligent inquiry, investigation and disclosure as to material facts relating to the issuer of the securities and to service such bonds. It is, moreover, essential that dealers offering such bonds to the public make certain that the offering circulars and other selling literature are based upon an adequate investigation so that they accurately reflect all material facts which a prudent investor should know in order to evaluate the offering before reaching an investment decision." In re Walston & Co., Inc., SEC Release No. 34-8165 (September 22, 1967).

(b) Escott v. Bar Chris Construction Corp., 283 F. Supp. 634 (S.D.N.Y. 1968).

(c) IDBs, Rule 415 and the increased use of Form S-3 by corporate issuers represent a diminished opportunity for Underwriters to conduct a reasonable investigation of the issuer and its affairs.

3. Counsel's Responsibilities.

(a) "In the distribution of unregistered securities, the preparation of an opinion letter is too essential and the reliance of the public too high to permit due diligence to be cast aside in the name of convenience. The public trust demands more of its legal advisers than 'customary' activities which prove to be careless." Securities and Exchange Commission v. Spectrum Ltd., 489 F.2d 535, 542 (2d Cir. 1973) (injunctive action).

(b) Counsel who issued an opinion which was "a critical step" in offering municipal securities ". . . has a duty to the investing public and does not act . . . as a mere scrivener of legal documents. At a minimum, when faced with facts which blaringly reveal that a fraud is being practiced on the investing public . . . counsel has a duty to take appropriate action." Brief for SEC, SEC v. Haswell, No. 78-1048 (10th Cir. July 17, 1981) (injunctive action).

(c) "Bond counsel were not expected to investigate the creditworthiness of the City. However, when put on notice of circumstances that called into question matters basic to the issuance of their opinion, bond counsel should have conducted an additional investigation. And bond counsel with knowledge of information material to investors should have taken all reasonable steps to satisfy themselves that those material facts were disclosed to the public. SEC Staff Report, Transactions in Securities of the City of New York, Ch. 6--"The Role of Bond Counsel", pp. 81-82 (August 26, 1977).

(d) Where Underwriter's counsel "signed and issued the opinion letter without questioning the omission from the offering circular of financial statements concerning the issuer's prior operating history, reviewing any documents as to the financial status of the issuer, or making inquiry as to results of operations of prior years". SEC Staff Report concludes "inquiry was totally inadequate." SEC Release No. 34-17831, Attorney's Conduct in Issuing an Opinion Letter Without Conducting an Inquiry of Underlying Facts Failed to Comport with Applicable Standards of Conduct (June 1, 1981) annexed as Exhibit G.

4. Municipal Finance Officers Association, Disclosure Guidelines for Offerings of Securities by State and Local Governments (1976).

   (a) MFOA Guidelines have been criticized as ineffective because of their voluntary nature. See, e.g., Letter dated August 17, 1979, from Chairman Williams to Senator Proxmire commenting on S. 1236.

B. Liability of the Municipal Issuer?

1. A private cause of action arising after June 1975 will presumably lie against municipal issuers under Section 10(b) of the 1934 Act in light of the amendment to the definition of "person" in Section 3(a)(9) of that Act expressly to include "government, or political subdivision, agency or instrumentality of a government." Cf. In re New York Municipal Securities Litigation, supra, annexed as Exhibit H.

2. Constitutional Considerations

   (a) Tenth Amendment--National League of Cities v. Usery, 426 U.S. 833 (1976)-- extension of Fair Labor Standards Act provision to state and local employees held an unconstitutional intrusion into an area of traditional governmental functions. It is doubtful that the Tenth Amendment affords a serious defense to an antifraud action under the Federal securities laws. See Woods v. Homes and Structures of Pittsburgh, Kansas, Inc., supra.

(b) Eleventh Amendment--bars private damage actions against states (Hans v. Louisiana, 134 U.S.1 (1890) but not local entities (Lincoln County v. Luning, 133 U.S. 529 (1890)). However, a state may waive its sovereign immunity with respect to Federal securities law violations by voluntarily involving itself in the sale and distribution of securities. Forman v. Community Services, Inc., 500 F.2d 1246 (2d Cir. 1974), rev'd on other grounds, 421 U.S. 837 (1975).

C. Liability of the Municipal Official

An official of a municipality acting solely in his official capacity cannot be held individually liable under Section 10(b) of the 1934 Act. In re New York Municipal Securities Litigation, supra.

D. Liability of Others

1. Bond Counsel

(a) Cronin v. Midwestern Oklahoma Development Authority, 619 F.2d 856 (10th Cir. 1980), reversing Franke v. Midwestern Oklahoma Development Authority, 428 F. Supp. 719 (W.D. Okla. 1976). In reversing summary judgment in favor of counsel and indicating that liability would ensue if plaintiff could show that lawyers and banks knowingly aided an underwriter in the fraudulent issuance of bonds, the Court stated that "the legal liability of bond lawyers is a new, relatively undeveloped issue" which should not be prematurely terminated.

(b) "[T]he purchaser of a new bond issue [can] expect these procedures--the underwriters' investigation and report, the accountant's certified financial statement, bond counsel's opinion letter, and the like--to have been faithfully performed . . . . Because plaintiff's allegations, if true, would support a finding that [defendant bond counsel's] misrepresentations and nondisclosure of material information acted to perpetuate a fraud by allowing to be offered for sale a bond issue that would otherwise not have succeeded, he is entitled to proceed beyond the pleading stage to attempt to prove his allegations." Shores v. Sklar, 610 F.2d 235 (10th Cir. 1980), rev'd on other grounds, 647 F.2d 462 (10th Cir. 1981).

(c) Opinion of bond counsel was a "prospectus" within the meaning of Section 2(1) of the 1933 Act which could afford a basis of the civil liability for misstatements or omissions under Section 12(2) of the Securities Act if the IDB in question is not properly exempt under Section 3(a)(2) of the Act. Baron, et al. v. Commercial & Industrial Bank of Memphis, 79-2 U.S. T.C. P9515, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,826 (S.D.N.Y. 1979). Contra, Nelson v. Quimby Island Reclamation District Facilities Commission, 491 F. Supp. 1364 (N.D. Cal. 1980).

2. Underwriters

(a) Section 10(b) of the Exchange Act applies to municipal securities and to the underwriters who sell them. In re New York Municipal Securities Litigation, supra.

(b) Temporary injunctions issued against underwriters who, "relying ostensibly upon unverified information supplied by [promoter] and without exercising due diligence", misrepresented various facts. SEC v. Astro Products of Kansas, Inc., supra.

3. The WPPSS default promises to be a fruitful source of litigation for plaintiffs' lawyers for years to come. See the Complaint annexed as Exhibit I in which plaintiff has sued (i) underwriters, (ii) construction engineers, (iii) bond counsel, (iv) rating agencies, and (v) an engineering and consulting firm alleging violations of Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. This is one of many private class actions commenced to date in this matter.

III. RECENT DEVELOPMENTS

A. The Taxable Municipal Bond. As of June 30, 1985, the Alaska Housing Finance Corporation had issued $1.452 billion of bonds, the interest on which is subject to Federal income tax (including $100 million sold in the Eurodollar market through a Netherlands Antilles finance subsidiary). The taxable status of interest on a municipal obligation will not necessarily affect the Section 3(a)(2) exemption from the registration requirements of the 1933 Act and the Section 3(a)(12) exemption from the registration and reporting requirements of the 1934 Act. See Alaska Housing Finance Corporation (available March 25, 1981) annexed as Exhibit J; Alaska Industrial Development Authority (available May 5, 1982).

B. The "Put" Bond. The right of the holder of a security to put the security to the

issuer as a result of a change in the interest rate might represent an offer of a new security which, unless exempted, must be the subject of an effective registration statement. The SEC has issued a no-action letter where the put was to the user of a facility financed with industrial development funds. The no-action letter request proposed two theories: an analogy to a guarantee (see I.A. 1(b)(i) supra), and an analogy to an exchange of securities with the issuer exempted by Section 3(a)(9) of the 1933 Act. Lord, Bissell & Brook (available November 5, 1981). Where the put is directly or indirectly to a non-bank financial institution its obligation would require registration--a process greatly facilitated by Rule 415 and Form S-3.

C. The so-called Capital Appreciation, Money Multiplier, Deferred Payment or Zero Coupon Bond. The bond is offered at a substantial discount from its ultimate principal value with no interest payments during its term. Among the issues raised by this security are: What principal amount is counted against a bonded debt limitation? What principal amount is issued for purposes of the annual state ceiling limitation on qualified mortgage bonds contained in Section 103A(g)? Can such obligations be issued in a jurisdiction where legislation does not permit bonds to be sold at a price of less than, e.g., 95% of par value?

IV. STATE SECURITIES LAW CONSIDERATIONS

A. In every state of the United States, other than Nevada and the District of Columbia, the public offering of a security must either be registered with the State Securities Commission or be exempt from the process. In certain instances, available exemptions must be

perfected by a filing with the State Securities Commission. The State Uniform Securities Act contains an exemption for ". . . any security, including a revenue obligation, issued or guaranteed by the United States, any state, any political subdivision of a state or any agency or corporate or other instrumentality of one or more of the foregoing . . . ." The following states (state statutory citation appears in parenthesis) have adopted the uniform exemption in exactly or substantially the foregoing form: Alabama (8-6-10(1)); Alaska (45.55.140(a)(1)); Arkansas 67-1248(1); California 25100(a); Colorado 11-51-113(1)(a); Connecticut 36-490(1); Delaware 7309(a)(1); Florida (517.051); Georgia (10-5-8(1)); Hawaii (485-4(1)); Idaho 30-1434(1); Illinois 3A.; Indiana (23-2-1-2(a)(1)); Kansas (17-1261(a)); Kentucky (292.400(1)); Louisiana (51:704(1)); Maine (873.1); Maryland (11-601.(1)); Massachusetts (402(a)(1)); Mississippi (75-71-201(1)); Missouri (409.402(a)(1)); Nebraska (8-1110(1)); New Jersey (49:3-50(a)(1)); New Mexico (58-13-29. A); New York (359-f.1.(a)); North Carolina (78A-16(1)); North Dakota (10-04-05.1); Oklahoma (401(a)(1)); Oregon (59.025(1)); Pennsylvania (202(a)) */; Puerto Rico 882.(a)(1); Rhode Island (7-11-8(b)); South Carolina (35-1-310(1)); Tennessee (48-16-103(a)(1)); Texas (5M) **/; Utah (61-1-14(1)(a)); Vermont (9-4203(1));

---

*/ Rules of Pennsylvania Securities Commissioner also require that the securities be tax-exempt.

**/ Rules of Commissioner of State Securities Board of Texas also require in the case of an industrial development bond that underlying credit be that of a corporation whose stock is listed on NYSE or ASE.

Virginia (13.1-514(a)(1)); West Virginia (32-4-402(a)(1)); Wyoming (17-4-114(i)).

The following states (which have also adopted the uniform exemption) distinguish revenue bonds or bonds not payable from a general tax for special treatment: Arizona (44-1843.1 and 44-1843.01); Iowa (502.202.1.); Michigan (451.802(1)); Minnesota (80A.151.(a)); Montana (30-10-104(1)); New Hampshire (421-B: 17 I(a)); Ohio (1707.02(A)(B)); South Dakota (47-31-67); Washington (21.20.310(1)); Wisconsin 851.22(1)).

EXHIBIT A

Section 3(a)(2) of the Securities Act of 1933

"(2) Any security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of one or more States or Territories. . . . or any security which is an industrial development bond (as defined in section 103(c)(2) of the Internal Revenue Code of 1954) the interest on which is excludable from gross income under section 103(a)(1) of such Code if, by reason of the application of paragraph (4) or (6) of section 103(c) of such Code (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security . . . ."

EXHIBIT B

"Rule 131. Definition of Security Issued Under Government Obligations.

"(a) Any part of an obligation evidenced by any bond, note, debenture, or other evidence of indebtedness issued by any governmental unit specified in Section 3(a)(2) of the Act which is payable from payments to be made in respect of property or money which is or will be used, under a lease, sale, or loan arrangement, by or for industrial or commercial enterprise, shall be deemed to be a separate 'security' within the meaning of Section 2(1) of the Act, issued by the lessee or obligor under the lease, sale or loan arrangement.

"(b) An obligation shall not be deemed a separate 'security' as defined in paragraph (a) hereof if, (1) the obligation is payable from the general revenues of a governmental unit, specified in Section 3(a)(2) of the Act, having other resources which may be used for payment of the obligation, or (2) the obligation relates to a public project or facility owned and operated by or on behalf of and under the control of a governmental unit specified in such section, or (3) the obligation relates to a facility which is leased to and under the control of an industrial or commercial enterprise but is a part of a public project which, as a whole, is owned by and under the general control of a governmental unit specified in such section, or an instrumentality thereof.

"(c) This rule shall apply to transactions of the character described in paragraph (a) only with respect to bonds, notes, debentures or other evidences of indebtedness sold after December 31, 1968."

OFFICIAL STATEMENT AND PROSPECTUS

$135,000,000

EXHIBIT C

Peninsula Ports Authority of Virginia

Coal Terminal Revenue Bonds, 1982 Series A

(Dominion Terminal Associates Project)

The Bonds are being issued to finance the acquisition and construction of coal port facilities in the City of Newport News, Virginia. The Bonds will be limited obligations of the Authority, payable from and secured by an assignment of revenues to be received by the Authority under a Lease with Dominion Terminal Associates, a Virginia general partnership, and from payments pursuant to an irrevocable Letter of Credit initially issued by

General Electric Credit Corporation

Dated October 15, 1982 **Due October 15, as set forth below**

The Letter of Credit will expire on October 31, 1997, and the Bonds are subject to mandatory redemption on October 15, 1997, unless the Letter of Credit is replaced by one or more Alternate Letters of Credit issued by one or more Credit Support Companies, as described herein.

The Bonds are subject to optional and mandatory redemption. See "THE BONDS—Redemption of Bonds."

The Bonds will be issuable as coupon Bonds in the denomination of $5,000 each, registrable as to principal only, and as fully registered Bonds without coupons in denominations of $5,000 or any integral multiple thereof. Coupon Bonds and fully registered Bonds without coupons will be exchangeable and transferable at the option of the holder. The principal of and premium, if any, and semi-annual interest (payable April 15 and October 15) on all Bonds will be payable at the principal corporate trust office of United Virginia Bank, Richmond, Virginia, as Trustee, or, in the case of coupon Bonds, at the option of the holder thereof, at the principal corporate trust office of Bankers Trust Company, New York, New York, as Paying Agent, except that interest on each fully registered Bond will be payable by check or draft mailed to the registered owner thereof.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS OFFICIAL STATEMENT AND PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

$20,000,000 Serial Bonds

Amount	Due October 15	Interest Rate	Yield or Price	Amount	Due October 15	Interest Rate	Yield or Price
$2,000,000	1985	6.75%	100%	$2,000,000	1990	8.25%	100%
2,000,000	1986	7.00	100	2,000,000	1991	8.50	100
2,000,000	1987	7.25	100	2,000,000	1992	8.75	100
2,000,000	1988	7.75	100	2,000,000	1993	9.00	100
2,000,000	1989	8.00	100	2,000,000	1994	9.20	100

$9,000,000 10% Bonds Due October 15, 1997—Price 100%

$21,000,000 10½% Bonds Due October 15, 2002—Price 100%

$85,000,000 10¾% Bonds Due October 15, 2012—Price 100%

(plus accrued interest)

	Price to Public(1)	Underwriting Discount(2)	Proceeds to Authority(1)(3)
er Unit	100%	2.558%(4)	97.442%
Total	$135,000,000	$3,453,300	$131,546,700

(1) Plus accrued interest from October 15, 1982.

(2) See "UNDERWRITING" for indemnification arrangements.

(3) Before deducting expenses of the offering, estimated at $1,312,000, which will be paid by Dominion Terminal Associates.

(4) Represents the weighted-average underwriting discount. See "UNDERWRITING."

In the opinion of Squire, Sanders & Dempsey, Bond Counsel, under the law existing on the date of original delivery of the Bonds, the interest thereon, except on any Bond for any period during which it is held by a "substantial user" of the Facilities described herein or a "related person," as those terms are used in Section 103(b)(13) of the Internal Revenue Code of 1954, as amended, is exempt from Federal income tax, and the Bonds, their transfer and the income therefrom, are exempt from all taxation by the Commonwealth of Virginia or any political subdivision thereof.

The Bonds are offered when, as and if issued by the Authority and accepted by the Underwriters and subject to approval of legality by Bond Counsel, and certain other conditions. It is expected that the Bonds will be available for delivery in New York, New York, on or about November 22, 1982.

Goldman, Sachs & Co. **Wheat, First Securities, Inc.**

The date of this Official Statement and Prospectus is November 12, 1982.

This Official Statement and Prospectus constitutes a prospectus with respect to the Letter of Credit issued by General Electric Credit Corporation, a New York corporation ("GECC"), in support of the $135,000,000 Peninsula Ports Authority of Virginia Coal Terminal Revenue Bonds, 1982 Series A (Dominion Terminal Associates Project). A registration statement with respect to such Bonds has not been filed under the Securities Act of 1933, as amended. GECC's executive headquarters are located at 570 Lexington Avenue, New York, New York 10022, and its administrative offices are located at 260 Long Ridge Road, Stamford, Connecticut 06902 (Telephone No. (203) 357-4000). Information concerning GECC is included or incorporated by reference in the Appendix hereto, and prospective investors are urged to review this information carefully.

AVAILABLE INFORMATION

GECC is subject to the informational requirements of the Securities Exchange Act of 1934 and in accordance therewith files reports and other information with the Securities and Exchange Commission (the "Commission"). Such reports and other information can be inspected and copied at Room 1024 at the office of the Commission, 450 Fifth Street N.W., Washington, D.C. 20549, as well as at the Regional Offices of the Commission at 219 South Dearborn Street, Chicago, Illinois 60604, 26 Federal Plaza, New York, New York 10278 and 10960 Wilshire Boulevard, Los Angeles, California 90024, and copies can be obtained by mail from the Public Reference Section of the Commission at Washington, D.C. 20549 at prescribed rates. Reports and other information concerning GECC can also be inspected at the offices of the New York Stock Exchange, 20 Broad Street, New York, New York 10005, on which certain of GECC's debt securities are listed.

GECC hereby undertakes to provide without charge to each person to whom a copy of this Official Statement and Prospectus has been delivered, on the written or oral request of such person, a copy of any or all of the documents referred to in the Appendix to this Official Statement and Prospectus which have been or may be incorporated in the Appendix to this Official Statement and Prospectus by reference, other than exhibits to such documents. Requests for such copies should be directed to James R. Bunt, Vice President and Comptroller, General Electric Credit Corporation, 260 Long Ridge Road, Stamford, Connecticut 06902, Telephone No. (203) 357-4000.

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY OVER-ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE BONDS AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

$135,000,000

Peninsula Ports Authority of Virginia
Coal Terminal Revenue Bonds, 1982 Series A
(Dominion Terminal Associates Project)

INTRODUCTORY STATEMENT

This Official Statement and Prospectus (the "Official Statement") provides information in connection with the offering by the Peninsula Ports Authority of Virginia (the "Authority") of its Peninsula Ports Authority of Virginia Coal Terminal Revenue Bonds, 1982 Series A (Dominion Terminal Associates Project), in the aggregate principal amount of $135,000,000 (the "Bonds"). The Bonds are being issued to finance the acquisition and construction of coal port facilities in Newport News, Virginia, in the Port of Hampton Roads (the "Facilities"). The Facilities will be operated by Dominion Terminal Associates, a general partnership under the Virginia Uniform Partnership Act ("DTA"), whose general partners are Armco Terminal Company, Ashland Terminal, Inc., Pittston Coal Terminal Corporation, Sierra Coal Company, and Westmoreland Terminal Company (individually a "Company" and collectively the "Companies"). The Companies are wholly owned subsidiaries of Armco Inc., Ashland Coal, Inc., The Pittston Company, Utah International Inc., and Westmoreland Coal Company, respectively (individually a "Parent" and collectively the "Parents").

The Authority will lease the Facilities to DTA under the terms of a Lease, dated as of October 15, 1982 (the "Lease"). The Lease will require DTA to make rental payments to the Authority sufficient to pay when due the principal of and premium, if any, and interest on the Bonds. Under the terms of a Throughput and Handling Agreement, dated as of October 15, 1982 (the "Throughput Agreement"), the Companies, severally and not jointly, will agree to make payments to DTA which in the aggregate will provide DTA with sufficient funds to make all rental payments due under the Lease. DTA will assign its rights to receive certain payments from the Companies under the Throughput Agreement to the Authority. The Bonds will be issued under an Indenture of Trust, dated as of October 15, 1982 (the "Indenture"), between the Authority and United Virginia Bank, Richmond, Virginia, as trustee (the "Trustee"). The Authority will assign to the Trustee its rights to receive rental payments from DTA under the Lease and its rights to receive payments from the Companies under the Throughput Agreement.

Pursuant to a Letter of Credit Agreement, dated as of October 15, 1982, General Electric Credit Corporation, a New York corporation ("GECC"), will deliver to the Trustee, for the account of DTA, an irrevocable letter of credit (the "GECC Letter of Credit"), obligating GECC to pay to the Trustee, upon demand and in accordance with the terms thereof, the principal of and premium, if any, and interest on the Bonds when due. The GECC Letter of Credit will expire on October 31, 1997. The GECC Letter of Credit may be replaced on October 15, 1997 with one or more Alternate Letters of Credit (an "Alternate Letter of Credit" and collectively the "Alternate Letters of Credit"), as to all or any portion of the outstanding Bonds. An Alternate Letter of Credit may be issued for a term of two or more years by GECC or by another credit support company (which may or may not be a commercial bank). As used herein, the term "Letter of Credit" shall refer to the GECC Letter of Credit and any and all Alternate Letters of Credit, and the term "Credit Support Company" shall refer to GECC and any and all other credit support companies. The principal amount of outstanding Bonds not supported by an Alternate Letter of Credit is subject to mandatory redemption on October 15, 1997. See "The Bonds—Mandatory Redemptions."

A payment default under the Lease or the Throughput Agreement or a bankruptcy of DTA or a Company or a Parent will not, by itself, result in acceleration of payment of the Bonds or in redemption of the Bonds prior to October 15, 1987. In the event of any such default or bankruptcy, the Credit Support Company will be obligated under the Letter of Credit to continue to make payments sufficient to pay the principal of and premium, if any, and interest on the Bonds until maturity or until earlier redemption on or

after October 15, 1987. For this reason, no descriptions are included in this Official Statement of the Lease, the Throughput Agreement or the business and properties of DTA, the Companies or the Parents.

The Bonds will be limited obligations of the Authority, will not be payable from the general funds of the Authority and will not constitute a pledge, charge, lien or encumbrance upon, or an assignment of, any of its income, receipts or revenues, except those specifically assigned under the Indenture. Neither the faith and credit nor the taxing power of the Commonwealth of Virginia or any political subdivision thereof will be pledged for the payment of the principal of or premium, if any, or interest on the Bonds and no holder of the Bonds will have the right to compel the exercise of the taxing power of the Commonwealth of Virginia or any political subdivision thereof in connection with any default thereon.

Brief descriptions of the Authority, the Facilities, the Bonds, the Letter of Credit and the Indenture are included in this Official Statement. All such descriptions are qualified in their entirety by reference to laws relating to or affecting the enforcement of creditors' rights. All references herein to the Letter of Credit, the Lease, the Throughput Agreement and the Indenture are qualified in their entirety by reference to such documents, and the description herein of the Bonds is qualified in its entirety by reference to the forms thereof and the information with respect thereto included in the aforesaid documents.

Information concerning GECC is included or incorporated by reference in the Appendix hereto. All information in the Appendix has been furnished by GECC and all information under the heading "THE FACILITIES" has been furnished by DTA.

THE AUTHORITY

The Authority is a body politic and corporate and a political subdivision of the Commonwealth of Virginia and is authorized and empowered under the laws of the Commonwealth of Virginia to issue its revenue bonds in order to acquire and construct coal port facilities in Newport News, Virginia, in the Port of Hampton Roads.

THE FACILITIES

The Facilities will consist of a coal storage and transshipment terminal to be constructed upon approximately 70 acres of land located on the northeast side of the James River in Newport News, Virginia, in the Port of Hampton Roads. The Facilities are expected to have an annual throughput capacity (based upon average rail car capacity, type of rail car couplers, number of storage piles and mechanical and operating efficiencies) of from 12 to 15 million tons per year utilizing ground storage of approximately 1.5 million tons. The Facilities will be served by a deep water channel approximately 45 feet deep. The pier facilities are designed to permit dredging to 55 feet without interruption of operations. The Facilities will have railroad service under a long-term transportation agreement with The Chesapeake & Ohio Railway Company. It is anticipated that initial shipments will take place in the second quarter of 1984.

USE OF PROCEEDS

It is estimated that the proceeds derived from the sale of the Bonds will be applied as follows:

Acquisition and Construction	$112,000,000
Net Interest During Construction	18,234,700
Bond Discount to Underwriters	3,453,300
Other Financing Expenses	1,312,000
Principal Amount of Bonds	$135,000,000

GECC will not receive any proceeds of the Bonds.

Pending application in the manner set forth above, the net proceeds will be invested as described herein under the "THE INDENTURE — Investment of Funds."

SOURCE OF PAYMENT AND SECURITY FOR BONDS

DTA will be required in the Lease to make rental payments to the Trustee sufficient to pay when due the principal of and premium, if any, and interest on the Bonds. The Companies, severally and not jointly, will agree in the Throughput Agreement to make payments to DTA which in the aggregate will provide DTA with sufficient funds to make all rental payments due under the Lease. To the extent that rental payments made under the Lease are not available to pay in full the principal of and premium, if any, and interest due on the Bonds on any Bond payment date, the Trustee will be required to draw moneys under the Letter of Credit in an amount sufficient to provide for the payment of the principal of and premium, if any, and interest on the Bonds due on that date.

The Bonds will be limited obligations of the Authority, will not be payable from the general funds of the Authority and will not constitute a pledge, charge, lien or encumbrance upon, or an assignment of, any of its income, receipts or revenues, except those specifically assigned under the Indenture. Neither the faith and credit nor the taxing power of the Commonwealth of Virginia or any political subdivision thereof will be pledged for the payment of the principal of or premium, if any, or interest on the Bonds and no holder of the Bonds will have the right to compel the exercise of the taxing power of the Commonwealth of Virginia or any political subdivision thereof in connection with any default thereon.

The Trustee's rights with respect to the Facilities are limited. Consequently, the Facilities will not provide any practical security for the Bonds.

THE BONDS

The Bonds will be issued in the aggregate principal amount of $135,000,000, will be dated October 15, 1982, will bear interest at the rates per annum set forth on the cover page hereof, payable semiannually on April 15 and October 15 of each year, commencing April 15, 1983, and will mature on October 15 in the years and in the principal amounts set forth on the cover page hereof. The Bonds will be issuable as coupon Bonds in the denomination of $5,000 each, registrable as to principal only, and as fully registered Bonds without coupons in denominations of $5,000 or any integral multiple thereof. Coupon Bonds and fully registered Bonds without coupons may be transferred or exchanged without cost, except for any tax or other governmental charge. The principal of and premium, if any, on all Bonds and interest on all coupon Bonds will be payable at the principal corporate trust office of the Trustee or, in the case of coupon Bonds, at the option of the holder thereof, at the principal corporate trust office of Bankers Trust Company, New York, New York, as Paying Agent (the "Paying Agent"). The interest on each fully registered Bond will be payable by check or draft mailed to the registered owner thereof.

Redemption of Bonds

The Bonds are subject to redemption prior to maturity as provided below under the headings "Optional Redemptions" and "Mandatory Redemptions."

Optional Redemptions

Optional Redemption On or After October 15, 1987. The Bonds are subject to redemption on or after October 15, 1987, either in whole at any time or in part (in any integral multiple of $5,000) on any interest payment date, upon payment in each case of the applicable redemption price, expressed as a percentage of the principal amount of the Bonds to be redeemed, set forth in the table below, together with interest accrued to the redemption date:

Redemption Period (dates inclusive)	Optional Redemption Price
October 15, 1987 to October 14, 1988	105 %
October 15, 1988 to October 14, 1989	104½
October 15, 1989 to October 14, 1990	104
October 15, 1990 to October 14, 1991	103½
October 15, 1991 to October 14, 1992	103
October 15, 1992 to October 14, 1993	102½
October 15, 1993 to October 14, 1994	102
October 15, 1994 to October 14, 1995	101½
October 15, 1995 to October 14, 1996	101
October 15, 1996 to October 14, 1997	100½
October 15, 1997 and thereafter	100

Extraordinary Optional Redemption. The Bonds are subject to redemption in whole, at the option of DTA, at a redemption price equal to the principal amount thereof, plus accrued interest thereon to the redemption date, on any date within 180 days following the adoption of the pertinent resolution of the Management Committee of DTA or the delivery of the opinion of counsel, as the case may be, described below, upon the occurrence of any one or more of the following events:

(a) The Facilities shall have been damaged or destroyed to such an extent that, in the opinion of DTA, as expressed in a resolution adopted by the Management Committee of DTA, (i) the Facilities could not be reasonably restored within a period of six months to the operating condition thereof immediately preceding such damage or destruction, or (ii) DTA is thereby prevented or is likely to be prevented from carrying on its normal operations at the Facilities for a period of six months; or

(b) Title to, or the temporary use of, all or substantially all of the Facilities shall have been taken under the exercise of the power of eminent domain by any governmental authority or sold in lieu thereof and such taking or sale, in the opinion of DTA, as expressed in a resolution adopted by the Management Committee of DTA, is likely to result in DTA being thereby prevented from carrying on its normal operations at the Facilities for a period of six months; or

(c) As a result of any changes in the Constitution of the Commonwealth of Virginia or the Constitution of the United States of America or as a result of legislation or administrative action (whether state or Federal) or by final decree, judgment or order of any court or administrative body (whether state or Federal) entered after the contest thereof by DTA in good faith, the Lease, in the opinion of independent counsel, shall have become void or unenforceable or impossible of performance in accordance with the intent and purposes of the parties thereto, or shall have been declared to be unlawful, or unreasonable burdens or excessive liabilities shall have been imposed on DTA, as expressed in a resolution adopted by the Management Committee of DTA, including, without limitation, Federal, state or other ad valorem, property, income or other taxes not being imposed on the date of the Lease; or

(d) Changes in the economic availability of or demand for labor, raw materials, operating supplies, energy sources or supplies or facilities necessary to operate the Facilities or technological, legal, market or other changes make the continued operation of the Facilities uneconomical in the opinion of DTA, as expressed in a resolution adopted by the Management Committee of DTA.

Mandatory Redemptions

Mandatory Partial Redemption. The Bonds maturing on October 15, 1997, on October 15, 2002, and on October 15, 2012 (collectively the "Term Bonds"), are subject to mandatory partial redemption on October 15 in the years (each such date is referred to herein as a "mandatory partial redemption date") and amounts shown below, at a redemption price equal to the principal amount thereof to be redeemed, plus accrued interest thereon to the redemption date:

Term Bonds Maturing on October 15, 1997		Term Bonds Maturing on October 15, 2002		Term Bonds Maturing on October 15, 2012	
October 15 of the Year	Principal Amount	October 15 of the Year	Principal Amount	October 15 of the Year	Principal Amount
1995	$3,000,000	1998	$3,000,000	2003	$ 6,000,000
1996	3,000,000	1999	4,000,000	2004	6,000,000
		2000	4,000,000	2005	7,000,000
		2001	5,000,000	2006	7,000,000
				2007	8,000,000
				2008	9,000,000
				2009	10,000,000
				2010	10,000,000
				2011	11,000,000

The Authority will receive a credit in respect of payments required to be made on any mandatory partial redemption date in an amount equal to the principal amount of any Term Bonds subject to mandatory partial redemption on such date that have been redeemed (otherwise than through a mandatory partial redemption) prior to such mandatory partial redemption date or purchased by DTA or any of the Companies or Parents and delivered to the Trustee for cancellation at least forty-five days prior to such date.

Mandatory Redemption Upon Certain Events of Taxability. The Bonds are subject to mandatory redemption in whole at a redemption price equal to the principal amount thereof, plus accrued interest thereon to the redemption date, on any date within 180 days after receipt by the Trustee of notice of (1) the issuance or modification or amendment of a published or private ruling of the Internal Revenue Service or a technical advice memorandum issued by the national office of the Internal Revenue Service in which DTA has participated or has been given the opportunity to participate and which ruling or memorandum DTA in its discretion does not contest by an appropriate proceeding directly or through a holder of a Bond, or (2) a final determination by any court of competent jurisdiction in the United States in a proceeding in which DTA has been given written notice and an opportunity to participate and defend, in either case, to the effect that, as a result of a failure by DTA to observe any covenant, agreement, representation or warranty in the Lease, the interest payable on the Bonds is includable in the gross income for Federal income tax purposes of the holders thereof (other than a "substantial user" of the Facilities or a "related person" as such terms are used in Section 103(b)(13) of the Internal Revenue Code of 1954, as amended—the "Code").

Mandatory Redemption Upon Noncompletion of Facilities. The Bonds are subject to mandatory redemption in whole in the event DTA fails to deliver to the Trustee evidence of the completion of the acquisition and construction of the Facilities (i) by October 15, 1985, or (ii) by October 15, 1986, in the event DTA is prevented from completing the acquisition and construction of the Facilities by October 15, 1985, as a result of circumstances beyond the control of DTA. In such event, the Bonds must be redeemed on any date within 180 days following the date on which evidence of the completion of the Facilities was due, at a redemption price equal to the principal amount thereof, plus accrued interest thereon to the redemption date.

Mandatory Redemption Upon Expiration of Letter of Credit. The Bonds are subject to mandatory redemption

(a) in whole on October 15, 1997, in the event that the GECC Letter of Credit is not replaced with any Alternate Letter of Credit;

(b) in part (in any integral multiple of $5,000) on October 15, 1997, in the event that Alternate Letter(s) of Credit are issued to replace the GECC Letter of Credit as to only a portion of the

—

outstanding Bonds, such redemption to be in a principal amount equal to the principal amount of the Bonds that will not be supported by the Alternate Letter(s) of Credit; and

(c) in whole or in part (in any integral multiple of $5,000) on the interest payment date next preceding the expiration date of an Alternate Letter of Credit, in the event that such Alternate Letter of Credit expires prior to October 31, 2012, and is not replaced, in whole or in part, by new Alternate Letter(s) of Credit, such redemption to be in a principal amount equal to the principal amount of the Bonds that will not be supported by new Alternate Letter(s) of Credit;

at a redemption price equal to the principal amount of the Bonds to be redeemed, plus accrued interest thereon to the redemption date.

Mandatory Redemption Upon Bankruptcy of Credit Support Company. The Bonds are subject to mandatory redemption in whole or in part (in any integral multiple of $5,000) upon the occurrence of certain events of bankruptcy with respect to a Credit Support Company, unless DTA causes an Alternate Letter of Credit to be issued within 180 days after any such event to replace the Letter of Credit issued by the bankrupt Credit Support Company, such redemption to be in a principal amount equal to the principal amount of the Bonds supported by the Letter of Credit issued by the bankrupt Credit Support Company that will not be supported by the new Alternate Letter of Credit, at a redemption price equal to the principal amount of the Bonds to be redeemed, plus accrued interest thereon to the redemption date. Such redemption shall be made on any date within forty-five days after the expiration of such 180-day period.

Notice of Redemption

Notice of redemption of any Bonds will be given by publication once a week for two successive weeks (the first publication to be at least thirty days before the date fixed for redemption) in a newspaper carrying financial news published at least weekly in the City of New York, New York, and in a newspaper of general circulation published at least weekly in the City of Richmond, Virginia, and by mailing a copy of the redemption notice to the holders of registered Bonds to be redeemed and to all other holders of Bonds who have filed their names and addresses with the Trustee for such purpose. Failure to give such notice by mailing or any defect in such notice will not affect the validity of the redemption.

Partial Redemptions

If less than all of the Bonds are called for redemption (other than pursuant to a mandatory partial redemption), DTA or the Credit Support Company, as the case may be, will be entitled to select the maturities to be redeemed and the principal amount of Bonds within such maturities to be redeemed. Within the maturities subject to redemption, the particular Bonds or portions thereof to be redeemed will be selected by lot by the Trustee. In the case of a mandatory partial redemption, within the maturities subject to redemption, the Term Bonds or portions thereof to be redeemed will be selected by lot by the Trustee.

Covenants Regarding Tax Exempt Status of Bonds

DTA covenants in the Lease that it will not approve, or permit to be approved on its behalf, any use of the proceeds of the Bonds if, as a result of such use, more than 10% of the net proceeds of the Bonds (including investment income therefrom but excluding accrued interest and amounts paid for expenses incurred in connection with the issuance of the Bonds) expended at that time would be considered as having been used for purposes other than payment of the costs of the acquisition and construction of docks, wharves or storage facilities within the meaning of Section 103(b)(4) of the Code, and that it will not take any action or omit to take any action that, if taken or omitted, would adversely affect the exemption of interest on the Bonds under the Code. DTA also covenants in the Lease that it will not make or direct the Trustee to make any investment that will cause the Bonds to be "arbitrage bonds" within the meaning of Section 103(c) of the Code.

Acceleration

The Bonds may be declared immediately due and payable upon a payment default on any Bond under certain conditions described under the caption "The Indenture—Events of Default and Remedies."

THE LETTER OF CREDIT

The following is a summary of certain provisions of the Letter of Credit.

GECC Letter of Credit

The GECC Letter of Credit is an irrevocable obligation of GECC to pay to the Trustee, upon demand and in accordance with the terms thereof, amounts sufficient to provide for the payment of the principal of and premium, if any, and interest due on the Bonds, whether at maturity, upon redemption or otherwise. The Indenture requires the Trustee to draw under the GECC Letter of Credit in order to obtain funds to provide for the payment of the principal of and premium, if any, and interest on the Bonds to the extent that rental payments made under the Lease are not available to pay in full the principal of and premium, if any, and interest due on the Bonds on any Bond payment date. In addition, in certain instances, the Trustee is required to use moneys drawn under the GECC Letter of Credit to purchase obligations of, or guaranteed as to principal and interest by, the United States of America ("Government Obligations"), which will be held in trust by the Trustee and used to pay the principal of and premium, if any, and interest on the Bonds on future Bond payment dates.

The amount available under the GECC Letter of Credit shall be reduced, without duplication, by (1) the principal amount of Bonds which are no longer deemed to be outstanding under the Indenture, (2) the amount of any drawing under the GECC Letter of Credit, (3) with respect to the amount available under the GECC Letter of Credit to pay interest on the Bonds, as of any date, such amount as may be in excess of the sum of (x) the interest to accrue on the Bonds through October 15, 1997, and (y) interest accrued prior to such date which remains unpaid, (4) with respect to the amount available under the GECC Letter of Credit to pay any redemption premium on the Bonds, as of the fifteenth Business Day after each interest payment date, such amount as may be in excess of the product of the then applicable redemption premium on the Bonds multiplied by the outstanding principal amount of the Bonds, and (5) the amount of any principal or interest or premium due in respect of the Bonds which remains unpaid fifteen Business Days after the date such amount was due and payable and as to which no drawing has been made prior to such fifteenth Business Day under the GECC Letter of Credit. As used herein "Business Day" shall mean any day other than a day on which banks in New York City are authorized or required by law or executive order to remain closed. After any such reduction, the Trustee shall no longer have any right to make a drawing under the GECC Letter of Credit in respect of the amount of principal or premium or interest on the Bonds causing or corresponding to such reduction.

In the GECC Letter of Credit, GECC covenants that it will not merge or consolidate with any other corporation or sell, convey, transfer or otherwise dispose of all or substantially all of its assets to any corporation, unless either GECC is the continuing corporation, or the successor corporation (if other than GECC) is a corporation organized and existing under the laws of the United States of America or a state thereof and such corporation expressly assumes all of GECC's obligations under the GECC Letter of Credit.

Term of GECC Letter of Credit; Alternate Letters of Credit

The GECC Letter of Credit and GECC's obligations thereunder will expire on October 31, 1997. The GECC Letter of Credit may be replaced on October 15, 1997 with one or more Alternate Letters of Credit issued by GECC, by one or more other Credit Support Companies or by GECC and such other Credit Support Companies. Any such Alternate Letter of Credit must be issued for a term of two or more years and must be in all other material respects the same as the GECC Letter of Credit. If more than one Alternate Letter of Credit is issued to replace the GECC Letter of Credit, all of the Alternate Letters of Credit must be issued for the same term. Any Alternate Letter of Credit that expires prior to October 31, 2012 may be replaced by one or more new Alternate Letters of Credit. As a condition to the substitution of any Alternate Letter of Credit (other than an Alternate Letter of Credit issued by GECC), DTA must furnish to the Trustee written evidence from Moody's Investors Service, Inc. ("Moody's"), if the Bonds are rated by Moody's, and from Standard & Poor's Corporation ("S&P"), if the Bonds are rated by S&P, to the effect that such rating agency has reviewed such Alternate Letter of Credit and that the proposed substitution will not cause a reduction in such rating agency's then applicable rating of the Bonds. GECC is not obligated to issue an Alternate Letter of Credit.

Upon the occurrence of certain events of bankruptcy with respect to a Credit Support Company, DTA may provide for the issuance of one or more Alternate Letters of Credit issued by one or more other Credit Support Companies to replace the Letter of Credit issued by the bankrupt Credit Support Company. As a condition to the substitution of any such Alternate Letter of Credit, DTA must furnish to the Trustee written evidence from Moody's, if the Bonds are rated by Moody's, and from S&P, if the Bonds are rated by S&P, to the effect that such rating agency has reviewed such Alternate Letter of Credit and that the proposed substitution of such Alternate Letter of Credit will not result in such rating agency's rating of the Bonds being lower than the second highest rating assigned by such rating agency. Any such Alternate Letter of Credit must be issued for a term which shall correspond with the terms of other outstanding Alternate Letters of Credit or, if there are no other outstanding Alternate Letters of Credit, for a term of two or more years and must be in all other material respects the same as the GECC Letter of Credit. If more than one Alternate Letter of Credit will be issued to replace the Letter of Credit issued by a bankrupt Credit Support Company, all of the Alternate Letters of Credit must be issued for the same term.

See "THE BONDS—Mandatory Redemptions" for a description of provisions requiring mandatory redemption of the Bonds upon the expiration of the GECC Letter of Credit or an Alternate Letter of Credit or upon the bankruptcy of a Credit Support Company in the event no Alternate Letter of Credit is issued.

THE INDENTURE

The following is a summary of certain provisions of the Indenture. Words and terms used in this summary that are defined in the Indenture shall have the same meanings as defined in the Indenture.

Assignment of Lease and Throughput Agreement

The Authority will assign to the Trustee all of the Authority's right, title and interest in and to the Lease (except certain indemnification rights and other rights reserved by the Authority) and to all rental payments required to be made by DTA under the Lease and to certain payments required to be made by the Companies under the Throughput Agreement as security for the payment of the principal of and premium, if any, and interest on the Bonds.

Acquisition and Construction Fund

The Indenture establishes an Acquisition and Construction Fund to be held by the Trustee. The net proceeds of the Bonds (exclusive of accrued interest initially deposited in the Bond Fund) will be deposited in the Acquisition and Construction Fund and applied to the payment of the cost of the acquisition and construction of the Facilities upon requisition therefor by DTA.

Bond Fund

The Indenture establishes a Bond Fund to be held by the Trustee. The accrued interest, if any, on the Bonds, moneys remaining in the Acquisition and Construction Fund after completion of the Facilities, rental payments made by DTA under the Lease, moneys drawn under the Letter of Credit and certain other moneys specified in the Indenture will be deposited in the Bond Fund. Moneys in the Bond Fund will be used solely for the payment of the principal of and premium, if any, and interest on the Bonds.

If a Bond or coupon is not presented to the Trustee for payment on its maturity or redemption date, the Trustee will hold moneys in the Bond Fund for the benefit of the holder of such Bond or coupon until such Bond or coupon is presented for payment. The Trustee will not have any obligation to invest such moneys and, if a matured Bond or coupon has not been presented for payment or redemption after four years from the date such Bond or coupon becomes due, the Trustee is obligated (after publication of notice required by the Indenture) to return such moneys to DTA, and the holder of such Bond or coupon must thereafter, as an unsecured general creditor, look only to DTA for payment of such Bond or coupon.

Investment of Funds

Moneys in the Acquisition and Construction Fund will, at the direction of DTA, be invested in (i) Government Obligations, (ii) obligations issued or guaranteed by any state or political subdivision thereof

rated A3 or higher by Moody's or A or higher by S&P; (iii) commercial or finance paper which is rated either P-1 or A-1 or an equivalent by Moody's or S&P; (iv) bankers' acceptances drawn on and accepted by commercial banks; (v) certificates of deposit or time deposits of banks or trust companies, including the Trustee or any commercial bank affiliated with the Trustee, organized under the laws of the United States of America or any state thereof, having a reported capital and surplus of at least $100 million; (vi) repurchase agreements fully secured by Government Obligations; and (vii) any other investment not prohibited by applicable law. Moneys in the Bond Fund will be invested in Government Obligations selected by the Trustee.

Events of Default and Remedies

Under the Indenture, (a) the failure to pay the interest on any Bond when and as the same becomes due and payable and the continuance of such failure for a period of two days, or (b) the failure to pay the principal of or premium, if any, on any Bond when and as the same becomes due and payable, will constitute an "Event of Default." Upon the occurrence and continuance of an Event of Default, the Trustee may, and upon the written request of the holders of not less than twenty-five percent in aggregate principal amount of Bonds then outstanding shall, declare the principal of all Bonds and the accrued interest thereon to the date of such declaration to be immediately due and payable. Upon the occurrence of an Event of Default under the Indenture and a declaration of acceleration of the Bonds, the Trustee shall declare all rental payments under the Lease to be immediately due and payable. In addition, the Trustee in its discretion may take any other action to enforce the rights of the holders of the Bonds and require the Authority or DTA or both to carry out any agreement for the benefit of such holders and perform their duties under the Lease and the Indenture and require the Credit Support Company to perform its obligations under the Letter of Credit. No remedy conferred upon the Trustee or the bondholders is exclusive of any other remedy. The Indenture contains no provision requiring that periodic evidence as to the absence of Events of Default or as to compliance with the terms of the Indenture be furnished.

The holders of a majority in aggregate principal amount of the Bonds outstanding may, under certain circumstances, annul a declaration of acceleration of payment of the Bonds, and any such annulment will automatically annul the corresponding acceleration of payment of all rental payments under the Lease. An annulment of a declaration of acceleration of payment of the Bonds will not, however, affect any subsequent Event of Default under the Indenture or impair any right or remedy of the Trustee or the bondholders with respect to such Event of Default.

The holders of a majority in aggregate principal amount of the Bonds outstanding at the time of an Event of Default may, by written notice, direct the method and place of conducting all remedial proceedings to be taken by the Trustee.

No holder of any Bond will have any right to institute any action, suit or proceeding in equity or at law for the execution of any trust under the Indenture or the pursuit of any remedy under the Indenture or under the Bonds unless (i) such bondholder previously has given to the Trustee written notice of an Event of Default, (ii) the holders of not less than twenty-five percent in aggregate principal amount of the Bonds then outstanding under the Indenture have made written request to the Trustee to do so and have afforded the Trustee a reasonable opportunity to exercise the powers granted in the Indenture or to institute such action, suit or proceeding, (iii) the Trustee has been offered satisfactory security and indemnity against the costs, expenses and liabilities to be incurred, and (iv) the Trustee has not complied with such request within a reasonable time. Nothing contained in the Indenture shall affect or impair the right of any bondholder to enforce the payment of the principal of and premium, if any, and interest on any Bond when due.

All moneys received by the Trustee p[illegible]ant to any right or remedy given or action taken under the provisions of the Indenture, after payment of the costs and expenses of the proceeding resulting in the collection of such moneys and the fees and expenses of the Trustee (except that moneys drawn under the Letter of Credit shall not be used for purposes other than payment of the Bonds), will be deposited by the Trustee in the Bond Fund and applied to the payment of the principal of and premium, if any, and interest then due and unpaid on the Bonds in accordance with the provisions of the Indenture.

Additional Bonds; Refunding Bonds

The Authority agrees, at the request of DTA and to the extent then permitted by law, to use its best efforts to issue from time to time one or more series of (i) Additional Bonds to provide moneys to pay any additional costs of the acquisition and construction of the Facilities and (ii) Refunding Bonds to refund any Bonds outstanding under the Indenture, subject in each case to the requirement that the issuance of the Additional Bonds or the Refunding Bonds not impair the excludability from income for Federal income tax purposes of interest on any Bonds then outstanding. Any Additional Bonds and Refunding Bonds will rank on a parity with and will be secured equally and ratably with all other Bonds outstanding under the Indenture and may only be issued if they are supported by a Letter of Credit.

Discharge of Indenture

In the event that all Bonds secured by the Indenture are paid or deemed paid in accordance with the Indenture, then the right and interest of the Trustee in and to the trust estate created in the Indenture and all covenants, agreements and other obligations of the Authority to the bondholders will thereupon cease, terminate and become void and be discharged and satisfied. In the event the Bonds of any series or the Bonds of any maturity within a series are paid or deemed paid in accordance with the Indenture, then such Bonds and the coupons appertaining thereto will cease to be entitled to any lien, benefit or security under the Indenture (other than the right to receive payment) and all covenants, agreements and other obligations of the Authority to the holders of such Bonds will thereupon cease, terminate and become void and be discharged and satisfied.

All Bonds or the Bonds of any one or more series or any one or more maturities within any one or more series or any combination thereof, and all coupons appertaining thereto, will be deemed to have been paid in accordance with the Indenture if and when (i) in the case such Bonds are to be redeemed on any date prior to their maturity, the Trustee shall have irrevocable instructions to publish a notice of redemption in accordance with the Indenture, (ii) there have been irrevocably deposited with the Trustee (a) moneys which will be sufficient to pay when due the principal of and premium, if any, and interest due and to become due on each such Bond on or prior to the redemption date or maturity thereof or (b) Government Obligations that are not redeemable by any person other than the holder and that mature and bear interest in such amounts and at such times as will provide sufficient moneys to pay when due the principal of and premium, if any, and interest due and to become due on each such Bond and coupon on and prior to the redemption date or maturity date thereof, and (iii) instructions have been given to the Trustee for the publication of notice that such Bonds and coupons are deemed to have been paid in accordance with the Indenture.

If all of the Bonds are paid or deemed paid in accordance with the Indenture, the Letter of Credit will terminate and the holders of the Bonds outstanding must look only to the trust funds held by the Trustee for payment of the Bonds.

The covenants of DTA regarding the tax-exempt status of the Bonds shall remain in full force and effect with respect to all Bonds until the principal of and premium, if any, and interest on the Bonds shall have been paid in full, notwithstanding that the lien of the Indenture has been discharged as a result of the deposit with the Trustee of moneys and/or Government Obligations in the manner provided above.

Modification of the Indenture, the Lease and the Letter of Credit

No amendment or modification may be made to the Indenture without the prior written consent of the Credit Support Company and DTA. After obtaining the consent of the Credit Support Company and DTA, the Authority and the Trustee may, without the consent of [illegible]ice to the bondholders, enter into supplemental Indentures (i) to specify and determine any matters relative to the Bonds which are not contrary to or inconsistent with the Indenture and which do not adversely affect the interest of the holders of the Bonds; (ii) to cure any defect, omission or ambiguity in the Indenture; (iii) to grant to or confer upon the Trustee for the benefit of the holders of the Bonds any additional rights, remedies, powers, authority or security which may be lawfully granted or conferred and which are not contrary to or

inconsistent with the Indenture; (iv) to add to the covenants and agreements of the Authority any other covenants and agreements to be observed by the Authority which are not contrary to or inconsistent with the Indenture; (v) to add to the limitations and restrictions in the Indenture other limitations and restrictions to be observed by the Authority which are not contrary to or inconsistent with the Indenture; (vi) to confirm, as further assurance, any assignment under, and the subjection to any claim, lien or assignment created or to be created by the Indenture of any revenues or receipts of the Authority or of any other moneys, securities or funds; (vii) to authorize and provide for the issuance in accordance with the terms of the Indenture of Additional Bonds or Refunding Bonds; or (viii) to make any other change that in the judgment of the Trustee does not adversely affect the interest of the holders of the Bonds. The consent of the holders of not less than a majority in aggregate principal amount of the Bonds then outstanding under the Indenture is required for the execution and delivery of any other supplemental Indentures, except that the consent of the holders of all of the Bonds then outstanding is required (i) to change the times, amounts or currency of payment of the principal of or premium, if any, or interest on any outstanding Bond, or reduce the principal amount or redemption price of any outstanding Bond or the rate of interest thereon, (ii) except for any parity claim, lien or assignment made in connection with the issuance of Additional Bonds or Refunding Bonds, to create a claim or lien upon, or an assignment of, the trust estate created under the Indenture ranking prior to or on a parity with the claim, lien or assignment created by the Indenture, (iii) to grant a preference or priority of any Bond or any Bonds over any other Bond or Bonds, or (iv) to reduce the percentages of the aggregate principal amount of the Bonds required for consents under the Indenture.

No amendment, change or modifications may be made to the Lease or the Letter of Credit without the prior written consent of the Credit Support Company. After obtaining the consent of the Credit Support Company, the Trustee may, without the consent of or notice to the bondholders, consent to any amendment, change or modification of the Lease or the Letter of Credit as may be required (i) in connection with the issuance of Additional Bonds or Refunding Bonds, (ii) for the purpose of curing any ambiguity or formal defect or omission, or (iii) in connection with any other change therein that, in the judgment of the Trustee, does not adversely affect the interest of the holders of the Bonds. The consent of the holders of not less than a majority of the Bonds then outstanding affected by any other amendment, change or modification of the Lease or the Letter of Credit is required for any such amendment, change or modification of the Lease or the Letter of Credit.

The Trustee

The Trustee may resign and be discharged of the trusts created by the Indenture by executing an instrument in writing filed with the Authority and DTA and by publishing notice of such resignation once a week for two consecutive weeks in a newspaper carrying financial news published at least weekly in the City of New York, New York, and in a newspaper of general circulation published at least weekly in the City of Richmond, Virginia, in the manner set forth in the Indenture. The Trustee may be removed at any time by an instrument in writing, appointing a successor, filed with the Trustee so removed by the holders of a majority of the Bonds then outstanding, provided that such removal will not take effect prior to the receipt of notice thereof, in writing, by DTA and the acceptance by such successor of its appointment. The Indenture provides for the appointment of a successor Trustee in the event of any vacancy in the office of Trustee.

The Trustee is under no obligation to enforce the trusts created by the Indenture unless requested to do so by the holders of at least twenty-five percent in aggregate principal amount of the Bonds at the time outstanding and may require indemnity satisfactory to it.

GECC, DTA, the Companies and the Parents maintain normal commercial banking relationships with theTrustee.

UNDERWRITING

Subject to the terms and conditions of the Underwriting Agreement, the Authority has agreed to sell to the Underwriters named below, and the Underwriters named below have severally agreed to purchase from the Authority the principal amount of the Bonds set forth opposite their names below.

Underwriter	Principal Amount of Bonds
Goldman, Sachs & Co.	$ 35,350,000
Wheat, First Securities, Inc.	35,350,000
Bear, Stearns & Co.	800,000
Blyth Eastman Paine Webber Incorporated	800,000
Alex. Brown & Sons	800,000
Clayton Brown & Associates, Inc.	800,000
Craigie Incorporated	800,000
Davenport & Co. of Virginia, Inc.	800,000
Dillon, Read & Co., Inc.	800,000
Donaldson, Lufkin & Jenrette Securities Corporation	800,000
Drexel Burnham Lambert Incorporated	800,000
The First Boston Corporation	800,000
Horner, Barksdale & Co.	800,000
E. F. Hutton & Company Inc.	800,000
Investment Corporation of Virginia	800,000
Kidder, Peabody & Co., Incorporated	800,000
Lazard Freres & Co.	800,000
Lehman Brothers Kuhn Loeb, Inc.	800,000
Merrill Lynch White Weld Capital Markets Group (MLPF&S, Inc.)	800,000
Morgan Stanley & Co., Inc.	800,000
John Nuveen & Co., Incorporated	800,000
Prudential-Bache Securities Inc.	800,000
L. F. Rothschild, Unterberg, Towbin	800,000
Salomon Brothers Inc	800,000
Scott & Stringfellow	800,000
Shearson/American Express Inc.	800,000
Smith Barney, Harris Upham & Co., Inc.	800,000
Thomson, McKinnon Securities Inc.	800,000
Warburg Paribas Becker A. G. Becker	800,000
Wertheim & Co., Inc.	800,000
Dean Witter Reynolds, Inc.	800,000
M. E. Allison & Co., Inc.	500,000
American Securities Corporation	500,000
Anderson & Strudwick	500,000
Robert W. Baird & Company, Incorporated	500,000
Barr Brothers & Co., Inc.	500,000
George K. Baum & Company	500,000
Bevill, Bresler & Schulman, Inc	500,000
William Blair & Company	500,000
J. C. Bradford & Co.	500,000
Branch, Cabell & Co.	500,000
Butcher & Singer, Inc.	500,000
The Cherokee Securities Company	500,000
Cowen & Company	500,000
Cumberland Securities Company, Inc.	$ 500,000
Dain Bosworth Inc.	500,000
A. Webster Dougherty & Co., Incorporated	500,000
A.G. Edwards & Sons, Inc.	500,000
Ehrlich-Bober & Co., Inc.	500,000
Equitable Securities Corporation	500,000
Glickenhaus & Co.	500,000
J. J. B. Hilliard, W.L. Lyons, Inc.	500,000
Howard, Weil, Labouisse, Friedrichs, Inc.	500,000
Hutchinson, Shockey, Erley & Co.	500,000
Interstate Securities Corporation	500,000
Janney Montgomery & Scott Inc.	500,000
Legg Mason Wood Walker, Inc.	500,000
Mabon, Nugent & Co.	500,000
Matthews & Wright Inc.	500,000
McDonald & Company	500,000
E. A. Moos & Co. Incorporated	500,000
Morgan, Keegan & Company, Inc.	500,000
Moseley, Hallgarten, Estabrook & Weeden Inc.	500,000
The Ohio Company	500,000
Oppenheimer & Co., Inc.	500,000
Piper, Jaffray & Hopwood Incorporated	500,000
Wm. E. Pollock & Co., Inc.	500,000
Prescott, Ball & Turben, Inc.	500,000
Rauscher Pierce Refsnes, Inc.	500,000
Refco Partners	500,000
Arch W. Roberts & Co.	500,000
Roosevelt & Cross, Inc.	500,000
Rotan Mosle, Inc.	500,000
Scharff & Jones, Incorporated	500,000
Herbert J. Sims & Co., Inc.	500,000
Stephens, Inc.	500,000
Sterne, Agee & Leach, Inc.	500,000
Stifel, Nicolaus & Company Incorporated	500,000
Tucker, Anthony, R. L. Day Inc.	500,000
UMIC, Inc.	500,000
Underwood, Neuhaus & Co., Incorporated	500,000
Vankampen Merritt Inc	500,000
Westcap Securities Inc.	500,000
A. Duncan Williams, Inc.	500,000
Adams, McEntee & Company	200,000
Advest, Inc.	200,000
Bailey and Associates, Inc.	200,000
Blunt Ellis & Loewi Incorporated	200,000

Underwriter	Principal Amount of Bonds
Brislin & Woram	$ 200,000
Buchanan & Co., Inc.	200,000
Burgess & Leith, Incorporated	200,000
Carolan & Company, Inc.	200,000
Carolina Securities Corporation	200,000
Cecil, Waller & Sterling, Inc.	200,000
Channer Newman Securities Company	200,000
R.W. Corby & Company, Inc.	200,000
Cralin Securities	200,000
Crews & Associates, Inc.	200,000
Cronin & Marcotte, Inc.	200,000
Crowell, Weedon & Company	200,000
Doft & Co., Inc.	200,000
Dorsey & Company, Inc.	200,000
Essex Company	200,000
Ferris & Company, Inc.	200,000
First Albany Corporation	200,000
First Birmingham Securities Corporation	200,000
First Charlotte Corporation	200,000
First Equity Corporation of Florida	200,000
First Huntington Securities Corp.	200,000
First of Michigan Corporation	200,000
Fischer, Johnson, Allen & Burke, Inc.	200,000
The Frazer Lanier Company	200,000
Gabriele, Hueglin & Cashman, Inc	200,000
Geo. B. Gibbons & Co., Inc.	200,000
Griffin, Kubik, Stephens & Thomson, Inc.	200,000
Gruntal & Co.	200,000
J.B. Hanauer & Co.	200,000
Hanauer, Stern & Co., Inc.	200,000
Hattier, Sanford & Reynoir	200,000
Frank Henjes & Company Inc.	200,000
Hereth, Orr & Jones	200,000
Herzfeld & Stern	200,000
William R. Hough & Co.	200,000

Underwriter	Principal Amount of Bonds
Johnson, Lane, Space, Smith & Co., Inc.	$ 200,000
Johnston, Lemon & Co., Inc.	200,000
Josephthal & Co.	200,000
Laidlaw, Adams & Peck, Inc.	200,000
The Leedy Corporation	200,000
M. G. Lewis & Co., Inc.	200,000
Lies, Tenner & Goldberg, Inc.	200,000
J. J. Lowrey & Co.	200,000
Mesirow & Co.	200,000
Moore & Schley Municipals Inc.	200,000
Leo Oppenheim & Company, Inc.	200,000
Park, Ryan Inc.	200,000
D. A. Pincus & Co., Inc.	200,000
Powell & Satterfield Inc.	200,000
Purcell, Graham & Co., Inc.	200,000
Samuel A. Ramirez & Company, Inc.	200,000
T. J. Raney & Sons, Inc.	200,000
Riviere Securities Corporation	200,000
Rooney, Pace, Inc.	200,000
R. Rowland & Co., Incorporated	200,000
Schneider, Bernet & Hickman, Inc.	200,000
Seattle-Northwest Securities Corporation	200,000
Donald Sheldon & Co., Inc.	200,000
Spelman & Co., Inc.	200,000
Stern Brothers & Co.	200,000
Stoever Glass & Co., Inc.	200,000
Strader & Co., Incorporated	200,000
Summers & Co., Inc.	200,000
Swiss American Securities, Inc.	200,000
Tripp & Co., Inc.	200,000
Vincent (Burton J.) Chesley & Co.	200,000
Warren W. York & Co., Inc.	200,000
Young Moore & Co., Inc.	200,000
A. W. Zucker & Co.	200,000
Total	$135,000,000

The Underwriters are committed to purchase all of the Bonds if any Bonds are purchased.

The Underwriters propose to offer the Bonds directly to the public at the initial public offering prices set forth on the cover page of this Official Statement. The underwriting discount set forth on the cover page of this Official Statement represents the weighted-average underwriting discount for the Bonds. The actual underwriting discount, expressed as a percentage of principal amount, will vary with the maturities of the Bonds as follows: 1.76% for Bonds due 1985 through 1989, 2.01% for Bonds due 1990 through 1994, 2.26% for Bonds due 1997, 2.51% for Bonds due 2002, and 2.76% for Bonds due 2012. The Underwriters may allow a concession not in excess of 0.5% of the principal amount for Bonds due 1985 through 1994, not in excess of 0.75% of the principal amount for Bonds due 1997 and Bonds due 2002, and not in excess of 1% of the principal amount for Bonds due 2012 to certain brokers and dealers. After the Bonds are released for sale to the public, the public offering prices and other selling terms may be changed by the Underwriters.

GECC and the Parents have agreed to indemnify the Underwriters against, and to contribute to losses arising out of certain civil liabilities, including certain liabilities under the Securities Act of 1933, as amended.

TAX EXEMPTION

In the opinion of Squire, Sanders & Dempsey, Bond Counsel, under the law existing on the date of the original delivery of the Bonds, the interest thereon, except on any Bond for any period during which it is held by a "substantial user" of the Facilities or a "related person," as those terms are used in Section 103(b)(13) of the Code, is exempt from Federal income tax, and the Bonds, their transfer and the income therefrom, are exempt from all taxation by the Commonwealth of Virginia or any political subdivision thereof. In rendering the foregoing opinion, Bond Counsel will receive and rely upon certifications and representations of fact made by or on behalf of DTA which Bond Counsel has not independently verified.

LEGAL MATTERS

The legality of the GECC Letter of Credit will be passed upon for GECC by Burton J. Kloster, Jr., Vice President-General Counsel and Secretary of GECC, and by White & Case, special counsel for GECC. As of October 11, 1982, Burton J. Kloster, Jr., together with members of his family, owned, had options to purchase and had other interests in an aggregate of approximately 6,664 shares of General Electric Company, the parent corporation of GECC.

Legal matters incident to the issuance of the Bonds and with regard to the tax-exempt status thereof (see "TAX EXEMPTION" herein) are subject to the approving legal opinion of Squire, Sanders & Dempsey, Bond Counsel. A signed copy of that opinion, dated and speaking only as of the date of original delivery of the Bonds, will be delivered to the Underwriters at the time of such original delivery, and a copy of the opinion will be printed on the Bonds. In its capacity as Bond Counsel, Squire, Sanders & Dempsey has participated in the preparation of, and has reviewed those portions of, this Official Statement pertaining to the Bonds, the Indenture, the Letter of Credit and the tax-exempt status of interest on the Bonds contained under the captions "THE AUTHORITY", "SOURCE OF PAYMENT AND SECURITY FOR BONDS", "THE BONDS", "THE LETTER OF CREDIT", "THE INDENTURE", "TAX EXEMPTION" and "LEGAL MATTERS" herein. Said firm has not been retained to pass upon any other information in this Official Statement, including the Appendix to this Official Statement and any information incorporated by reference therein.

Certain other legal matters will be passed upon for DTA by Cravath, Swaine & Moore, New York, New York, and by McGuire, Woods & Battle, Richmond, Virginia, for the Companies by their respective counsel, for GECC by Burton J. Kloster, Jr., Vice President-General Counsel and Secretary of GECC, and by White & Case, New York, New York, special counsel for GECC, for the Authority by Jones, Blechman, Woltz & Kelly, P.C., Newport News, Virginia, and for the Underwriters by King & Spalding, Atlanta, Georgia.

Underwriter		Principal Amount of Bonds
Brialin & Woram	$	200,000
Buchanan & Co., Inc.		200,000
Burgess & Leith, Incorporated		200,000
Carolan & Company, Inc.		200,000
Carolina Securities Corporation		200,000
Cecil, Waller & Sterling, Inc.		200,000
Channer Newman Securities Company		200,000
R. W. Corby & Company, Inc.		200,000
Cralin Securities		200,000
Crews & Associates, Inc.		200,000
Cronin & Marcotte, Inc.		200,000
Crowell, Weedon & Company		200,000
Doft & Co., Inc.		200,000
Dorsey & Company, Inc.		200,000
Essex Company		200,000
Ferris & Company, Inc.		200,000
First Albany Corporation		200,000
First Birmingham Securities Corporation		200,000
First Charlotte Corporation		200,000
First Equity Corporation of Florida		200,000
First Huntington Securities Corp.		200,000
First of Michigan Corporation		200,000
Fischer, Johnson, Allen & Burke, Inc.		200,000
The Frazer Lanier Company		200,000
Gabriele, Hueglin & Cashman, Inc		200,000
Geo. B. Gibbons & Co., Inc.		200,000
Griffin, Kubik, Stephens & Thomson, Inc.		200,000
Gruntal & Co.		200,000
J.B. Hanauer & Co.		200,000
Hanauer, Stern & Co., Inc.		200,000
Hattier, Sanford & Reynoir		200,000
Frank Henjes & Company Inc.		200,000
Hereth, Orr & Jones		200,000
Herzfeld & Stern		200,000
William R. Hough & Co.		200,000

Underwriter		Principal Amount of Bonds
Johnson, Lane, Space, Smith & Co., Inc.	$	200,000
Johnston, Lemon & Co., Inc.		200,000
Josephthal & Co.		200,000
Laidlaw, Adams & Peck, Inc.		200,000
The Leedy Corporation		200,000
M. G. Lewis & Co., Inc.		200,000
Liss, Tenner & Goldberg, Inc.		200,000
J. J. Lowrey & Co.		200,000
Mesirow & Co.		200,000
Moore & Schley Municipals Inc.		200,000
Leo Oppenheim & Company, Inc.		200,000
Park, Ryan Inc.		200,000
D. A. Pincus & Co., Inc.		200,000
Powell & Satterfield Inc.		200,000
Purcell, Graham & Co., Inc.		200,000
Samuel A. Ramirez & Company, Inc.		200,000
T. J. Raney & Sons, Inc.		200,000
Riviere Securities Corporation		200,000
Rooney, Pace, Inc.		200,000
R. Rowland & Co., Incorporated		200,000
Schneider, Bernet & Hickman, Inc.		200,000
Seattle-Northwest Securities Corporation		200,000
Donald Sheldon & Co., Inc.		200,000
Spelman & Co., Inc.		200,000
Stern Brothers & Co.		200,000
Stoever Glass & Co., Inc.		200,000
Strader & Co., Incorporated		200,000
Summers & Co., Inc.		200,000
Swiss American Securities, Inc.		200,000
Tripp & Co., Inc.		200,000
Vincent (Burton J.) Cheslay & Co.		200,000
Warren W. York & Co., Inc.		200,000
Young Moore & Co., Inc.		200,000
A. W. Zucker & Co.		200,000
Total		$135,000,000

The Underwriters are committed to purchase all of the Bonds if any Bonds are purchased.

The Underwriters propose to offer the Bonds directly to the public at the initial public offering prices set forth on the cover page of this Official Statement. The underwriting discount set forth on the cover page of this Official Statement represents the weighted-average underwriting discount for the Bonds. The actual underwriting discount, expressed as a percentage of principal amount, will vary with the maturities of the Bonds as follows: 1.76% for Bonds due 1985 through 1989, 2.01% for Bonds due 1990 through 1994, 2.26% for Bonds due 1997, 2.51% for Bonds due 2002, and 2.76% for Bonds due 2012. The Underwriters may allow a concession not in excess of 0.5% of the principal amount for Bonds due 1985 through 1994, not in excess of 0.75% of the principal amount for Bonds due 1997 and Bonds due 2002, and not in excess of 1% of the principal amount for Bonds due 2012 to certain brokers and dealers. After the Bonds are released for sale to the public, the public offering prices and other selling terms may be changed by the Underwriters.

GECC and the Parents have agreed to indemnify the Underwriters against, and to contribute to losses arising out of certain civil liabilities, including certain liabilities under the Securities Act of 1933, as amended.

TAX EXEMPTION

In the opinion of Squire, Sanders & Dempsey, Bond Counsel, under the law existing on the date of the original delivery of the Bonds, the interest thereon, except on any Bond for any period during which it is held by a "substantial user" of the Facilities or a "related person," as those terms are used in Section 103(b)(13) of the Code, is exempt from Federal income tax, and the Bonds, their transfer and the income therefrom, are exempt from all taxation by the Commonwealth of Virginia or any political subdivision thereof. In rendering the foregoing opinion, Bond Counsel will receive and rely upon certifications and representations of fact made by or on behalf of DTA which Bond Counsel has not independently verified.

LEGAL MATTERS

The legality of the GECC Letter of Credit will be passed upon for GECC by Burton J. Kloster, Jr., Vice President-General Counsel and Secretary of GECC, and by White & Case, special counsel for GECC. As of October 11, 1982, Burton J. Kloster, Jr., together with members of his family, owned, had options to purchase and had other interests in an aggregate of approximately 6,664 shares of General Electric Company, the parent corporation of GECC.

Legal matters incident to the issuance of the Bonds and with regard to the tax-exempt status thereof (see "TAX EXEMPTION" herein) are subject to the approving legal opinion of Squire, Sanders & Dempsey, Bond Counsel. A signed copy of that opinion, dated and speaking only as of the date of original delivery of the Bonds, will be delivered to the Underwriters at the time of such original delivery, and a copy of the opinion will be printed on the Bonds. In its capacity as Bond Counsel, Squire, Sanders & Dempsey has participated in the preparation of, and has reviewed those portions of, this Official Statement pertaining to the Bonds, the Indenture, the Letter of Credit and the tax-exempt status of interest on the Bonds contained under the captions "THE AUTHORITY", "SOURCE OF PAYMENT AND SECURITY FOR BONDS", "THE BONDS", "THE LETTER OF CREDIT", "THE INDENTURE", "TAX EXEMPTION" and "LEGAL MATTERS" herein. Said firm has not been retained to pass upon any other information in this Official Statement, including the Appendix to this Official Statement and any information incorporated by reference therein.

Certain other legal matters will be passed upon for DTA by Cravath, Swaine & Moore, New York, New York, and by McGuire, Woods & Battle, Richmond, Virginia, for the Companies by their respective counsel, for GECC by Burton J. Kloster, Jr., Vice President-General Counsel and Secretary of GECC, and by White & Case, New York, New York, special counsel for GECC, for the Authority by Jones, Blechman, Woltz & Kelly, P.C., Newport News, Virginia, and for the Underwriters by King & Spalding, Atlanta, Georgia.

DOCUMENTS INCORPORATED BY REFERENCE

There is hereby incorporated in this Appendix to the Official Statement and Prospectus by reference General Electric Credit Corporation's Annual Report on Form 10-K for the fiscal year ended December 31, 1981 and General Electric Credit Corporation's Quarterly Reports on Form 10-Q for the quarters ended March 27, 1982, June 26, 1982, and September 25, 1982, heretofore filed with the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934, as amended (the "1934 Act"), to which reference is hereby made.

All documents filed by General Electric Credit Corporation pursuant to Sections 13(a), 13(c), 14 or 15(d) of the 1934 Act after the date of this Official Statement and Prospectus and prior to the termination of the offering of the Bonds offered hereby shall be deemed to be incorporated in this Appendix to the Official Statement and Prospectus by reference and to be a part hereof from the date of filing of such documents.

GENERAL ELECTRIC CREDIT CORPORATION

General Electric Credit Corporation (herein together with its subsidiaries called GECC unless the context otherwise requires) was incorporated in 1943 in the State of New York, under the provisions of the New York Banking Law relating to investment companies, as successor to General Electric Contracts Corporation, formed in 1932. All outstanding capital stock of GECC is owned by General Electric Company (herein called General Electric). The business of GECC originally related principally to financing the distribution and sale of consumer and other products of General Electric. Subsequently, however, the type and brand of products financed and type of credit granted have been significantly diversified, and virtually all products financed are manufactured by companies other than General Electric. Substantially all of the products financed by GECC are new products.

GECC operates primarily in the finance industry and, to a lesser degree, in the life insurance industry and the fire and casualty insurance industry. Finance industry activities include retail time sales and retailer inventory financing of home products (major appliances, television sets, furniture and other home furnishings); revolving credit financing for retail merchants; family financial services (direct cash, home equity and home modernization loans and accounts receivable financing for small personal loan companies); time sales financing of marine products; automobile leasing; commercial and industrial equipment sales financing provided through time sales, loans and leases; industrial loans and leases; accounts receivable financing; residential financing (principally time sales and dealer inventory financing of mobile homes and, to a lesser degree, time sales and dealer inventory financing of recreational vehicles); real estate loans; mortgage insurance; and mortgage banking. Property, credit life, and accident and health insurance is made available to GECC's finance customers through two insurance subsidiaries and through outside carriers. Both these insurance subsidiaries also sell insurance to others. The life insurance subsidiary offers individual term and whole life, credit life and accident and health insurance and group life and accident and health insurance. Another insurance subsidiary offers property and casualty insurance. For these insurance subsidiaries, more than one-half of their premiums are generated from other than GECC customers.

GECC's executive headquarters are located at 570 Lexington Avenue, New York, New York 10022, and its administrative offices are located at 260 Long Ridge Road, Stamford, Connecticut 06902 (Telephone No. (203) 357-4000). Services of GECC are offered domestically and in Puerto Rico.

CONSOLIDATED RATIO OF EARNINGS TO FIXED CHARGES

Year Ended December 31,					(Unaudited) Nine Months Ended September 25, 1982
1977	1978	1979	1980	1981	
1.34	1.27	1.20	1.18	1.16	1.20

For purposes of computing the consolidated ratio of earnings to fixed charges, earnings consist of net earnings to which has been added provision for income taxes and fixed charges. Fixed charges consist of interest on all indebtedness and one-third of annual rentals, which GECC believes is a reasonable approximation of the interest factor of such rentals.

EXPERTS

The consolidated financial statements and schedule of General Electric Credit Corporation and subsidiaries included in GECC's Annual Report on Form 10-K for 1981 have been incorporated in this Appendix by reference in reliance upon the report set forth therein of Peat, Marwick, Mitchell & Co., independent certified public accountants, and upon the authority of said firm as experts in accounting and auditing.

No dealer, salesman or other person has been authorized to give any information or to make any representations, other than those contained in this Official Statement and Prospectus, in connection with the offer contained in this Official Statement and Prospectus, and, if given or made, such information or representations must not be relied upon as having been authorized by the Authority, DTA, GECC or the Underwriters. Neither the delivery of this Official Statement and Prospectus nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the facts herein set forth since the date hereof. This Official Statement and Prospectus does not constitute an offer or solicitation by anyone in any jurisdiction in which such offer or solicitation is not authorized or in which the person making such offer or solicitation is not qualified to do so or to anyone to whom it is unlawful to make such offer or solicitation.

TABLE OF CONTENTS

$135,000,000

Peninsula Ports Authority of Virginia Coal Terminal Revenue Bonds, 1982 Series A

(Dominion Terminal Associates Project)

OFFICIAL STATEMENT AND PROSPECTUS

Goldman, Sachs & Co.
Wheat, First Securities, Inc.

November 12, 1982

EXHIBIT D

<u>Section 3(a)(29) of the Securities Exchange Act of 1934</u>

"(29) The term 'municipal securities' means securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond (as defined in section 103(c)(2) of the Internal Revenue Code of 1954) the interest on which is excludable from gross income under section 103(a)(1) of such Code if, by reason of the application of paragraph (4) or (6) of section 103(c) of such Code (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security."

132

EXHIBIT E

UNITED STATES DISTRICT COURT
For the
NORTHERN DISTRICT OF MISSISSIPPI

Northern Division

SECURITIES AND EXCHANGE COMMISSION,	:
Plaintiff,	:
v.	:
CALHOUN COUNTY MEDICAL FACILITY, INC., a Mississippi corporation; BULLINGTON-SCHAS & CO., INC., a Tennessee corporation; A. DULANEY TIPTON; TERRY ALLEN FROST; and JERALD H. SKLAR,	:
Defendants.	:

STIPULATION AND CONSENT

Plaintiff Securities and Exchange Commission (the "Commission") and Defendant Jerald H. Sklar ("Sklar"), by and through their respective attorneys, hereby stipulate and agree as follows:

1. Defendant Sklar:

a. Consents to the jurisdiction of this Court over him and over the subject matter of this action and acknowledges service upon and receipt by him of the Commission's Complaint herein;

b. Waives notice of the entry of the attached Final Order, and consents without his admitting or denying the allegations of the Complaint, ..ept as to jurisdiction, that the annexed Final Order may be presented by Plaintiff Commission to the Court for signature and entry;

c. States that he enters into this Stipulation and Consent voluntarily and that, except for the representations of the Commission set forth herein, no promise or threat of any kind has been made to him

or to any representative of his by the Commission or any member, officer, agent, employee or representative thereof to induce him to enter into this Consent, and that the Stipulation and Consent is entered into for the purpose of resolving the instant action and has no bearing on and shall not in any way prejudice or otherwise affect any other proceeding, civil, administrative or criminal, by any other governmental agency or private party, which has been or may be instituted;

d. Undertakes and agrees not to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon a purchaser of securities;

e. Undertakes to have the law firm in which he is a partner establish the following procedures:

> i. insisting that the issuers of industrial development bonds that Mr. Sklar and his law firm represent in the future will furnish the firm with appropriate audited financial statements that have been certified by an independent accountant and insisting that the same information be furnished by the issuer when Mr. Sklar or the firm represents any other party, such as the underwriter or fiscal agent, involved in the distribution of such securities;
>
> ii. meeting bi-weekly with all partners and associates of the firm involved in bond distributions to review all pending matters involving bond distributions;
>
> iii. requiring the approval of at least three partners before a legal opinion is issued by the firm affecting the distribution of securities;
>
> iv. delineating the scope of the firm's role and obligation both in an engagement letter to be presented to the issuer and underwriter in transactions in which the firm is to act as bond counsel, in connection with the issuance of securities, and in the official statment;

v. declining to participate in any industrial development bond offering unless the issuer, underwriter and other participants in the offering are each represented by counsel who are knowledgeable (and current in their knowledge) about the requirements of the federal securities laws; and

vi. requiring partners and associates in the law firm practicing securities law to update their familiarity with the federal securities laws by attending, at least annually, appropriate continuing legal education programs.

f. Undertakes to make himself available to and shall appear at any trial or hearing or pretrial deposition in the above-captioned action at the oral or written request of the Commission, communicated to him or to his counsel of record herein, without requiring that such a subpoena be served upon him requiring such appearance; provided, however, that such request shall be communicated no less than two weeks before the Commission desires his attendance at any such trial, hearing or pre-trial discovery proceeding; and provided further, that if at the time any such notice respecting pre-trial deposition is communicated to him, Sklar shall be outside the United States, the time of his appearance shall be subject to reasonable adjustment except with respect to any trial or hearing as to which, if he receives the aforesaid notice, he shall appear on the date(s) requested;

g. States that he enters into this Stipulation and Consent to terminate these proceedings and to avoid the expenditure of additional cost and time, prior to any hearing, trial, adjudication or presentation of evidence;

h. Consents to the Court's retention of jurisdiction over him solely for the purpose of enforcing or modifying the terms and conditions contained in the Final Order and the Stipulation and Consent.

2. Plaintiff Commission:

a. Stipulates that it shall not institute any proceedings against Sklar or any law firm with which he is or may become associated under Rule 2(e) of the Commission's Rules of Practice [17 C.F.R. 201.2(e)] based solely upon (i) any of the allegations set forth in the Complaint filed in these proceedings; or (ii) the filing of the Complaint herein; or (iii) the entry of the Stipulation and Consent herein; or (iv) the entry of the Final Order herein. It is further stipulated that, in the event that a Rule 2(e) proceeding is instituted, if the independent factual and legal bases for such proceeding were not proven, the proceeding would be dismissed and no sanction would be imposed.

b. Stipulates that neither the entry of this Stipulation and Consent, nor the entry of the Final Order, nor the filing of the Commission's Complaint herein, nor the allegations set forth in the Commission's Complaint, shall be required to be disclosed in any proxy or registration statement, or offering statement, or any filing required to be made with the Commission under the federal securities laws, by any client of Mr. Sklar or by the client of any law firm with which Mr. Sklar is or may become associated (where Mr. Sklar acts solely in the capacity of attorney for such client and not in any other capacity defined in Securities Act Rule 405 [17 C.F.R. 230.405] such as officer, director, parent, affiliate, associate, control person or promoter of such client).

3. Plaintiff Commission and Defendant Sklar:

a. State that this Stipulation and Consent does not constitute any evidence or admission of any wrongdoing by Mr. Sklar, or an adjudication by the Court with respect to any issue of fact or law, and

that no part of either this Stipulation and Consent or the Final Order is intended to have collateral estoppel effect upon Sklar or to preclude Sklar from fully litigating any such issue of fact or law in any other forum or jurisdiction.

b. Waive the entry of findings of fact and conclusions of law as to the issues involved herein pursuant to Rule 52 of the Federal Rules of Civil Procedure.

DATED: May 19, 1981

Harvey L. Pitt

HARVEY L. PITT
Attorney for Defendant
JERALD H. SKLAR

Joseph L. Grant

JOSEPH L. GRANT
Attorney for Plaintiff
SECURITIES AND EXCHANGE COMMISSION

APPROVED:

Jerald H Sklar

JERALD H. SKLAR

EXHIBIT F

SECURITIES ACT OF 1933
Release No. 5523/August 21, 1974

Admin. Proc. File No. 3-4528

In the Matter of

JO M. FERGUSON
127 Gibson Road
Louisville, Kentucky

ORDER INSTITUTING PROCEEDINGS AND IMPOSING SANCTION PURSUANT TO RULE 2(e) OF THE COMMISSION'S RULES OF PRACTICE

Jo M. Ferguson, an attorney, has submitted an offer of settlement in connection with proceedings proposed to be instituted pursuant to Rule 2(e) of the Commission's Rules of Practice. 1/ Solely for the purpose of these proceedings, respondent consents to their institution and to the findings made herein, without admitting or denying those findings, and to the sanction imposed by this order.

Accordingly, IT IS ORDERED that proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice be, and they hereby are, instituted against respondent.

On the basis of the offer of settlement, it is found that respondent was bond counsel and that in addition he assumed principal legal responsibility for reviewing a prospectus (or "official statement") used in the offer and sale through the mails of $4,425,000 in City of Covington Health Case Project revenue bonds, issued in 1972 to finance the construction of a nursing home in Covington, Kentucky. It is further found that while acting in this capacity, respondent willfully aided and abetted violations of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder in that:

1. The prospectus failed to disclose that:

a. Senex Corporation, developer of the project, had entered into a contract with a local contractor to construct the nursing home for a contract price which was $650,000 less than the price for which it had negotiated and agreed with city officials to construct the facility;

b. The purportedly independent consultant who passed on the need for and feasibility of the project had an agreement to share 50 percent of the developer's profits;

c. Two feasibility consultants, one of which had been specifically hired to render an opinion about the project, had rendered reports bearing unfavorably on the need for such a project;

d. The project's financial adviser, which received a fee of $135,000, was owned and controlled by the developer;

e. An independent securities dealer could not be found to underwrite the bonds; and

f. The financial adviser caused itself to be appointed underwriter for the issue.

2. Because of his review of the prospectus, his pre-existing relationship with the developer on other offerings of municipal bonds, and other factors which had come to his attention, respondent should have known, if he did not know, that the prospectus omitted material facts. 2/

In determining to accept the offer of settlement, the Commission considered various mitigative factors, including the voluntary adoption by respondent and his firm of a number of corrective changes in the firm's procedures relative to municipal bonds, 3/ and the fact that neither Ferguson nor his firm has been a respondent in prior Rule 2(e) proceedings or a defendant in an injunctive action brought by the Commission.

Accordingly, IT IS ORDERED that Jo M. Ferguson be, and he hereby is, censured.

For the Commission, by the Office of Opinions and Review, pursuant to delegated authority.

George A. Fitzsimmons
Secretary

1/ Rule 2(e) provides, in pertinent part, that: "The Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of and opportunity for hearing in the matter (i) not to possess the requisite qualifications to represent others, or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the federal security laws...or the rules and regulations thereunder."

2/ The prospectus is alleged in *SEC* v. *Senex et al.*, Civil Action No. 74-53 (E.D. Ky. 1974) to be part of a deceptive scheme engaged in by Senex and others.

3/ Among these changes are the following procedures: (1) Every two weeks, members of the firm meet and discuss all of their active cases. Affirmative approval of each partner is required before the issuance of any legal opinion. (2) The firm will undertake an appropriate investigation in connection with acting as bond counsel including, among other things, obtaining independently-audited financial statements and inquiring into the background of the various parties connected with the offering. Written evidence of such investigations and the results thereof will be reviewed by the partners of the firm. (3) An appropriate "engagement letter" will be sent to all interested parties, emphasizing that the firm's duty is to the issuer and the bondholders. It will define the scope of the firm's work as bond counsel and require submission to it of certain pertinent information. (4) The firm will require that it receive inde-

pendently-audited financial statements, representations from appropriate interested persons concerning the accuracy and completeness of the statements about them in any offering circulars, and a statement from counsel for any lessee or guarantor that such counsel has reviewed the offering circular and is aware of no inaccuracies therein. (5) Partners and associates of the firm will attend, at least annually, municipal bond workshops and seminars.

SECURITIES EXCHANGE ACT OF 1934
Release No. 17831/June 1, 1981

ATTORNEY'S CONDUCT IN ISSUING AN OPINION LETTER WITHOUT CONDUCTING AN INQUIRY OF UNDERLYING FACTS FAILED TO COMPORT WITH APPLICABLE STANDARDS OF CONDUCT

INTRODUCTION

After consideration by the Commission of the role of the lawyer who represented an underwriter in the public offering of certain industrial revenue bonds, the Commission has determined, in the exercise of its prosecutorial discretion, not to institute an enforcement proceeding against that person, charging aiding and abetting of violations of antifraud provisions of the federal securities laws.[1] This decision not to bring an enforcement action is not based on any conclusion that the lawyer's conduct was even arguably acceptable; to the contrary, the Commission believes that the lawyer failed to carry out his professional obligations under the circumstances described below and, as a result, facilitated violations of the securities laws.[2] The Commission has taken into account certain other factors, including his unfamiliarity with the federal securities laws and the fact that he relied, in a manner inappropriate under the circumstances, upon bond counsel, an experienced securities lawyer. The Commission believes, however, that the public and the bar should be apprised of the conduct of the lawyer in this case and of the Commission's views as to the responsibilities of lawyers who render opinions in connection with securities transactions which affect public investors.

THE FACTS

In 1977, William M. Gotten, an attorney in Memphis, Tennessee, rendered an opinion, as counsel for an underwriter, in connection with the offer and sale of industrial revenue bonds not required to be registered pursuant to the Securities Act of 1933. The opinion letter, which was drafted for Mr. Gotten's signature by bond counsel in the transaction, falsely stated that the offering circular did not "omit to state a material fact necessary to make the statements therein, in the light of the circumstances under which they were made, not misleading".

---

[1] The Commission is issuing this Report in accordance with its authority under Section 21(a) of the Securities Exchange Act. For further information concerning the related civil action filed against others, see Litigation Release No. 9366.

[2] *Ibid.*

Unlike many other industrial bond offerings which are intended to provide funds for the construction of new facilities, the offering in this case was for the purpose of acquiring an existing hospital, which had operated for several years. While the offering circular contained projections of revenues, expenses and earnings, it contained no financial information about the past operations of the hospital. This operating history reflected adversely upon the possibility of future profitable operations and drew into serious question the ability of the issuer to service the debt being issued.

For five years prior to the offering, net income ranged from a loss to a $48,000 profit during a time when the hospital hed no mortgage indebtedness or other debt service. Interest expense alone for the first five years of the bond sale was to average about $155,000 per year, or in excess of $100,000 more than the hospital had ever made as profit in the preceding 5 year period. Under a new management company which had operated the hospital during the year immediately preceding the bond offering, with no debt to service, a net profit from operations was realized of only $24,000. Debt service on the new bonds thus required more than $158,000, or an amount equivalent to more than 600% of the hospital's profits during the previous year. This information, clearly both relevant and material to the reasonableness of the income projections, was not disclosed.

Mr. Gotten read the offering circular prior to rendering his opinion. And, although the opinion letter states that the signator has not independently checked or verified most of the material statements in the offering circular, Mr. Gotten, who knew that the issuer was a going concern that had been in operation for a number of years, signed and issued the opinion letter without questioning the omission from the offering circular of financial statements concerning the issuer's prior operating history, reviewing any documents as to the financial status of the issuer, or making inquiry as to results of the operations of prior years.[3] This inquiry was totally inadequate and facilitated the bond closing and the bond sales to the public.

---

[3] In that letter, Mr. Gotten also opined that the bonds were exempt from registration with the Commission under the Securities Act and that compliance with the Trust Indenture Act was not required. Although these opinions turned out to be

DISCUSSION

The nature of services performed by lawyers in connection with securities transactions frequently involves the rendering of opinions concerning compliance by their clients with the federal securities laws. This is so because legal opinions are often essential to the completion of the transactions, and the parties and the investing public look to the opinion as the authoritative statement that the matters opined upon are in order. The importance of the role of counsel who render legal opinions in this context has prompted the bar to establish professional standards for lawyers who provide them. The American Bar Association's Committee on Ethics and Professional Responsibility, for example, has addressed the duties of counsel who render securities law opinions in Formal Opinion 335, 60 A.B.A. Jour. 488 (1974).

Formal Opinion 335 relates to opinions written as the basis for transactions involving sales of unregistered securities and establishes that, as a matter of professional standards, a lawyer must make a preliminary inquiry of the client as to the relevant facts before rendering an opinion as to compliance with the federal securities laws. When the facts obtained from the client appear incomplete or inconsistent with facts known to the lawyer, or are otherwise suspect, the lawyer must make further inquiry.[4] And, if after such further in-

---

FOOTNOTE, Continued

correct, Mr. Gotten had made no attempt to ascertain their applicability or accuracy; instead he relied upon the representations of, among others, the underwriter and bond counsel.

[4] Guidance as to when further inquiry is appropriate is provided in Formal Opinion 335 which states:

> "* * * the lawyer should, in the first instance, make inquiry of his client as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in a material respect; or are suspect, or are inconsistent; or either on their face or on the basis of other known facts are open to question, the lawyer should

quiry, the lawyer is not satisfied as to all the relevant facts, he should refuse to render an opinion.[5]

In addition, Canon 6 of the Model Code of Professional Responsibility of the American Bar Association requires that a lawyer represent his client competently. And Disciplinary Rule 6–101(A) expressly mandates that an attorney shall not handle a legal matter which he knows or should know he is not competent to handle, without associating himself with a lawyer who is competent to handle it, and shall not handle a legal matter without preparation adequate in the circumstances.

The smooth functioning of the securities markets will be subject to serious disruption if the public cannot safely rely on the expertise proffered by lawyers rendering their opinions. Unless lawyers carefully and competently ascertain the relevant facts, and make a reasonable inquiry of their clients to obtain facts not within their personal knowledge, their opinions may facilitate fraudulent transactions in securities. This is so particularly as the investing public looks to the lawyer's opinion as a safeguard against violations of the federal securities laws. As stated by the United States Court of Appeals for the Second Circuit in *Securities and Exchange Commission* v. *Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973), in discussing the conduct of an attorney who, without conducting any inquiry into the underlying facts, issued a false opinion letter that unregistered shares could be sold without registration, "the preparation of an opinion letter is too essential and the reliance of the public too high to permit due diligence to be cast aside in the name of convenience."[6]

---

make further inquiry." 60 A.B.A. Jour. at 489.

[5] Again, guidance is provided in Formal Opinion 335 which cautions:

> "Where the lawyer concludes that further inquiry of a reasonable nature would not give him sufficient confidence as to all the relevant facts, or for any other reason he does not make the appropriate further inquiries, he should refuse to give an opinion." *Id.*

[6] *See also United States* v. *Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964) involving an opinion that

The Commission has also stated,

> "If an attorney furnishes an opinion based solely on hypothetical facts which he has made no effort to verify, and if he knows that his opinion will be relied upon as the basis for a substantial distribution of unregistered securities, a serious question arises as to the propriety of his professional conduct."

FOOTNOTE, Continued

certain securities were exempt from registration under Section 3(a)(1) of the Securities Act:

> "In our complex society . . . the lawyer's opinion can be [an] instrument for inflicting pecuniary loss more potent than the chisel or the crowbar. * * * Congress could not have intended that men holding themselves out as members of these ancient professions [the accounting and legal professions] should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess."

And see Securities and Exchange Commission v. *Universal Major Industries, Corp.*, 546 F.2d 1044 (2d Cir. 1976), *cert. denied*, 434 U.S. 834 (1977) (opinion that securities could be sold without registration); *Securities and Exchange Commission* v. *Frank*, 388 F.2d 486 (2d Cr. 1968) (failure of lawyer in drafting a prospectus to make inquiry beyond the facts supplied to him by his client, facts which even a laymen would know were false);

United States v. *Crosby*, 294 F.2d 928 (2d Cir. 1961) (opinion that unregistered stock was freely transferable); *Escott* v. *Barchris Construction Co.*, 283 F. Supp 642 (S.D.N.Y. 1968) (failure to investigate the accuracy of registration statement signed by the attorney); *cf. Securities and Exchange Commission* v. *Coven*, 581 F.2d 1020 (2d Cir. 1978), *cert. denied*, 440 U.S. 590 (1979) (letter representing that a sufficient number of shares had been sold to facilitate the closing of an "all or nothing" offering); *Securities and Exchange Commission* v. *Manor Nursing Centers, Inc.*, 458 F.2d

Securities Act Release No. 4445 (Securities Exchange Act Release No. 6721), published on February 2, 1962 (cited with approval by the Commission in Securities Act Release No. 5168, July 7, 1971).[7]

CONCLUSION

Under the circumstances described above concerning Mr. Gotten's conduct in rendering an opinion letter, and based on the standards of conduct articulated above, the Commission believes that Mr. Gotten's conduct, without having conducted any inquiry of his client as to the underlying facts on which his opinion was predicated, failed to satisfy applicable standards.

By the Commission.

George A. Fitzsimmons
Secretary

1082 (2d Cir. 1972) (failure to correct a misleading prospectus).

[7] In Release No. 4445, the Commission noted the practice of dealers, when attempting to obtain an exemption under Section 4(1) of the Securities Act, of submitting representations to a lawyer that the sellers of the securities did not hold any of those positions that would render the exemption unavailable. The release stated that a lawyer's opinion based on hypothetical facts would be worthless if the facts were not accurate or if the vital facts were not considered. The release further expounded on the duties of responsible counsel to the effect that "it is the practice of responsible counsel not to furnish an opinion * * * unless such counsel have themselves carefully examined all of the relevant circumstances * * * ." *Id.*

In re NEW YORK CITY MUNICIPAL SECURITIES LITIGATION.

MDL 314.

United States District Court, S. D. New York.

Jan. 25, 1980.

Actions arising out of the near financial collapse of the city of New York were brought under the Securities Act of 1933 and the Securities Exchange Act of 1934 and upon pendent state law claims. The District Court, Owen, J., held that: (1) sections of the Securities Act of 1933 and Securities Exchange Act of 1934 relied upon were not applicable to issuers of municipal securities, as opposed to underwriters and sellers, and (2) in view of substantive federal legislation excluding local governments from liability in suits under federal securities legislation, federal district court lacked power to adjudicate pendent state law claims.

Motions of city defendants to dismiss granted, and those of underwriter and seller defendants denied.

1. Securities Regulation 🔑41

Securities Exchange Act was designed to provide for regulation of securities exchanges and of over-the-counter markets to prevent inequitable and unfair practices in such exchanges and markets. Securities Act of 1933, § 17(a), 15 U.S.C.A. § 77q(a); Securities Exchange Act of 1934, §§ 3(a)(12), 10(b) as amended 15 U.S.C.A. §§ 78c(a)(12), 78j(b).

2. Securities Regulation 🔑42

Congress by including section defining "exempted security" in Securities Exchange Act contemplated that, at least for some purposes, governmental securities, including those of municipalities, would be exempted from certain of its requirements. Securities Exchange Act of 1934, §§ 3(a)(12), 10(b) as amended 15 U.S.C.A. §§ 78c(a)(12), 78j(b).

3. Securities Regulation 🔑42

Securities Exchange Act provision defining "exempted security" is strictly definitional, and whether or not given substantive section applies to "exempted securities" is left to express language of particular section, but it was intended that antifraud provision of Act extend to fraudulent conduct in connection with all securities in broadest sense, including those defined as "exempted securities". Securities Exchange Act of 1934, §§ 3(a)(12), 7(a), 8(a), 9(f), 10(b), 12(a), 14(a), 15(a)(1), 16(a–c) as amended 15 U.S.C.A. §§ 78c(a)(12), 78g(a), 78h(a), 78i(f), 78j(b), 78l(a), 78n(a), 78o(a)(1), 78p(a–c).

4. Securities Regulation 🔑42

Addition of municipal and state securities to category of "exempted securities" as defined in Securities Exchange Act evidences congressional decision to avoid political and economic consequences of unequal treatment of federal, state and municipal securities. Securities Exchange Act of 1934, §§ 3(a)(12), 10(b) as amended 15 U.S.C.A. §§ 78c(a)(12), 78j(b).

5. Securities Regulation 🔑42, 117

Implied cause of action under antifraud provision of Securities and Exchange Act exists in favor of purchasers of municipal securities. Securities Exchange Act of 1934, §§ 3(a)(10, 12), 10(b) as amended 15 U.S.C.A. §§ 78c(a)(10, 12), 78j(b).

6. Securities Regulation 🔑134, 143

Plaintiff securities purchaser suing under antifraud provision of Securities Exchange Act as opposed to provision for liability of person who offers or sells by means of prospectus or oral communication including untrue statement or failing to include material fact necessary to make statements not misleading avoids restrictive provisions of 1933 Act and, specifically, circumvents one-year statute of limitations and rescission measure of damages but, on other hand, must bear much heavier burden of proving scienter and loses advantage of 1933 Act requirement that defendant carry burden of going forward with his "due dili-

gence" defense. Securities Act of 1933, §§ 3(a)(2), 12(2), 13, 15 U.S.C.A. §§ 77c(a)(2), 77l(2), 77m; Securities Exchange Act of 1934, § 10(b) as amended 15 U.S.C.A. § 78j(b).

7. Securities Regulation ⟹117

Antifraud provision of Securities Exchange Act extends to transactions in municipal securities but liability does not reach municipal issuer, latter not being "person" as defined in the 1934 Act. Securities Act of 1933, § 2(2), 15 U.S.C.A. § 77b(2); Securities Exchange Act of 1934, §§ 3(a)(9), 10(b) as amended 15 U.S.C.A. §§ 78c(a)(9), 78j(b).

See publication Words and Phrases for other judicial constructions and definitions.

8. Securities Regulation ⟹27, 172, 192

Provision of Securities Act of 1933 making it unlawful for any person in offering or selling securities by use of instrument of interstate commerce or by use of mails to employ device, scheme or artifice to defraud, to obtain money or property by untrue statement of material fact or omission to state material fact necessary to make statements not misleading, or to engage in any transaction, practice or course of business which operates or would operate as fraud or deceit upon purchaser is only provision of 1933 Act to which 1933 Act definition of exempted securities does not apply, and does no more than provide basis for criminal prosecution and Securities and Exchange Commission injunctive proceedings. Securities Act of 1933, §§ 3(a)(2), 5, 12(2), 17(a), 15 U.S.C.A. §§ 78c(a)(2), 77e, 77l(2), 77q(a).

9. Securities Regulation ⟹117

Underwriters and sellers are liable under antifraud provision of Securities Exchange Act for their own independent fraudulent conduct in connection with municipal securities. Securities Act of 1933, §§ 5, 12(2), 15 U.S.C.A. §§ 77e, 77l(2); Securities Exchange Act of 1934, § 10(b) as amended 15 U.S.C.A. § 78j(b).

10. Securities Regulation ⟹42

Tower Amendments of Securities Exchange Act attempted to limit "collateral effect" of 1975 amendments on issuers so as to insure that 1934 Act as amended will not tamper in any way with prerogatives of state and local governments in their sale of securities. Securities Exchange Act of 1934, §§ 10(b), 15B, 15B(d) as amended 15 U.S.C.A. §§ 78j(b), 78o-4, 78o-4(d).

11. Securities Regulation ⟹117

City could not be held liable under antifraud provisions of Securities Exchange Act either as principal or as aider and abettor, and where complaints alleged that mayor and comptroller acted solely within their official capacities, they could not be held individually liable under such provision. Securities Exchange Act of 1934, § 10(b) as amended 15 U.S.C.A. § 78j(b).

12. Securities Regulation ⟹104

The 1933 Securities Act provision making it unlawful for person in offering or selling securities by use of instrument of interstate commerce or by use of mails to employ device, scheme, or artifice te defraud or to obtain money or property by untrue statement of material fact or omission to state material fact necessary to make statements not misleading or to engage in any transaction, practice or course of business which operates or would operate as fraud or deceit upon purchaser must be viewed together with express civil liability provisions of other sections of same Act, one of which specifically provides private remedy to defrauded investor but expressly excludes exempted securities, and thus private right of action against municipal issuers does not exist under such first-mentioned section. Securities Act of 1933, § 17(a), 15 U.S.C.A. § 77q(a).

13. Federal Courts ⟹17

In view of substantive federal legislation excluding local governments from liability in suits under federal securities legislation, federal district court lacked power to adjudicate pendent state law claims. Securities Act of 1933, § 17(a), 15 U.S.C.A. § 77q(a); Securities Exchange Act of 1934, § 10(b) as amended 15 U.S.C.A. § 78j(b).

14. Indemnity ⇨13.1(2)

Indemnification is not available for underwriters in securities fraud case. Securities Act of 1933, § 17(a), 15 U.S.C.A. § 77q(a); Securities Exchange Act of 1934, § 10(b) as amended 15 U.S.C.A. § 78j(b).

15. Contribution ⇨5(6)

Contribution may only be required of joint tort-feasor, and city defendants which were not subject to liability under antifraud provisions of federal securities laws were not subject to claim for contribution. Securities Act of 1933, § 17(a), 15 U.S.C.A. § 77q(a); Securities Exchange Act of 1934, § 10(b) as amended 15 U.S.C.A. § 78j(b).

Pomerantz, Levy, Haudek & Block, New York City by Richard M. Meyer, Eugene H. Zagat, Jr., William E. Haudek, New York City, for Friedlandler class plaintiffs.

Gold, Farrell & Marks by Thomas R. Farrell, New York City, for Spector class plaintiffs.

William M. Weisberg, New York City, for plaintiffs Goldfarb and Weisberg.

Teitler & Teitler by Michael F. Teitler, New York City, for plaintiff World Airways, Inc.

Allen G. Schwartz, Corp. Counsel by Bruce S. Kaplan, Chief Asst. Corp. Counsel, John F. Grubin, Steven Been, James M. Kaplan, Asst. Corp. Counsels, New York City, of counsel, for municipal defendants City of New York, Abraham Beame and Harrison Goldin.

Barry R. Ostrager, Kathleen Schaaf, Simpson, Thacher & Bartlett, New York City, for Manufacturers Hanover Trust Co.

Irwin J. Sugarman, Schulte & McGoldrick, New York City, for Ehrlich-Bober & Co., Inc.

Robert P. Beshar, New York City, for Weeden & Co.

M. William Munno, Paul Batista, Seward & Kissel, New York City, for Bank of America.

Stephen A. Weiner, Robert J. Sussman, Winthrop, Stimson, Putnam & Roberts, New York City, for Bear, Stearns & Co.

Laura B. Hoguet, Richard J. Holwell, White & Case, New York City, for Bankers Trust Co.

Ronald L. Cohen, Donovan, Leisure, Newton & Irvine, New York City, for A. G. Becker & Co., Inc.

Thomas A. Shaw, Jr., Breed, Abbott & Morgan, New York City, Paul B. Galvani, George M. Moriarty, Ropes & Gray, Boston, Mass., for First Nat. Bank of Boston.

Evan A. Davis, Edmund H. Kerr, Cleary, Gottlieb, Steen & Hamilton, New York City, for Salomon Bros.

Lowell G. Harriss, Davis, Polk & Wardwell, New York City, for Morgan Guaranty Trust Co.

W. Foster Wollen, Paul A. Merolla, Shearman & Sterling, New York City, for Citibank, N. A.

Richard C. Casey, Joseph G. Riemer, III, Brown, Wood, Ivey, Mitchell & Petty, New York City, for Merrill Lynch, Pierce, Fenner & Smith, Inc.

Gregory A. Markel, Cravath, Swaine & Moore, New York City, for Chemical Bank.

Jon Paul Robbins, Nitkin, Alkalay, Handler & Robbins, New York City, for First Pennco Securities Inc.

Briscoe R. Smith, Toni C. Lichstein, Milbank, Tweed, Hadley & McCloy, New York City, for The Chase Manhattan Bank, Nat. Assn.

OPINION

OWEN, District Judge.

In this multi-faceted litigation, before me for pretrial purposes pursuant to an order of the Judicial Panel on Multidistrict Litigation, there are various motions to dismiss. These actions have a common origin in the near financial collapse of the City of New York in late 1974 and early 1975.[1] The several complaints allege that the City of New York, former Mayor Abraham Beame-

1. *See SEC Staff Report on Transactions in Securities of the City of New York* (1977).

and Comptroller Harrison Goldin (the "City Defendants"), and certain banks and brokerage firms (the "Underwriter and Seller Defendants") deliberately misled the public as to the City's desperate financial condition in connection with the underwriting and subsequent resale of various New York City obligations issued during 1974 and 1975.[2] Plaintiffs allege that the foregoing constitutes violations of Section 17(a) of the Securities Act of 1933 (the "Securities Act" or the "1933 Act"), 15 U.S.C. § 77q(a), and Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act" or the "1934 Act"), 15 U.S.C. § 78j(b), and Rule 10b–5 promulgated thereunder, 17 C.F.R. § 240.10b–5.

Eleven separate lawsuits have been consolidated for pretrial matters in this litigation.[3] In five of the actions, the City is named as a defendant along with the underwriters and sellers.[4] Two of the actions have been certified as class actions pursuant to Fed.R.Civ.P. 23(b)(3), *Friedlander v. City of New York*, 71 F.R.D. 546 (S.D.N.Y. 1976), and *Spector v. City of New York*, 71 F.R.D. 550 (S.D.N.Y.1976). In *Friedlander*, plaintiffs allege that on June 1, 1974, New York City had outstanding $4.4 billion in short-term notes, of which the defendant banks held approximately $3.5 billion, and of which large clients of the defendant brokers owned approximately $900 million. (Plaintiff's Complaint at ¶ 31.) According to the complaint, on the basis of "inside" information that the City was unable to repay these obligations, the underwriter defendants underwrote for distribution to the general public approximately $2.6 billion of the City's notes. The proceeds of these sales were allegedly to be used to "bail out" the banks' and brokerage firms' own holdings of City notes by reducing those holdings from $4.4 billion in June 1974 to $1.9 billion in June 1975. The City of New York and its Mayor and Comptroller are alleged to have aided and abetted the foregoing acts by, *inter alia*, concealing the City's critical financial condition from the public and falsifying certain records to conceal the fiscal crisis. The *Friedlander* class consists of the first non-dealer purchasers of the City's Revenue Anticipation Notes (the "RANS") issued on December 13, 1974, January 13, 1975, February 14, 1975 and the City's Bond Anticipation Notes issued March 12, 1975. *See Friedlander v. City of New York*, 71 F.R.D. 548, 548 (S.D.N.Y. 1976).

The *Spector* class consists of the holders of the City's general obligation bonds who purchased such bonds between May 1, 1974 and September 30, 1975. Plaintiffs allege that the commercial banks and brokerage firms conspired to conceal information as to the City's desperate financial condition from the investing public. These acts of concealment, along with other short term steps designed to avoid default, were al-

2. The underwriter and seller defendants include the Chase Manhattan Bank, N.A., First National City Bank, Manufacturers Hanover Trust Company, The First National Bank of Boston, Chemical Bank, Bank of America N.T. & S.A., Morgan Guaranty Trust Company of New York, Bankers Trust Company (the "Banks"), and Weeden & Co., Inc., A. G. Becker & Co., Inc., Bear, Stearns & Co., Ehrlich-Bober & Co., Inc., First Pennco Securities, Inc., Salomon Brothers, Merrill Lynch, Pierce, Fenner & Smith Inc. (the "Brokers").

3. This court has jurisdiction for pretrial purposes over the following cases: *Truncell v. The First National Bank of Boston*, 76–3285–C (D.Mass.1976); *Friedlander v. The First National Bank of Boston*, 76–2685–T (D.Mass. 1976); *Truncell v. Bank of America N.T. & S.A.*, C76-1873-SC (N.D.Cal.1976); *World Airways, Inc. v. Bank of America, N.T. & S.A.*, C78-0042-WAI (N.D.Cal.1978); *Friedlander v. Bank of America N.T. & S.A.*, C76-1432-SAW (N.D.Cal.1976); *World Airways, Inc. v. Salomon Brothers*, 78 Civ. 0072 (S.D.N.Y.1978); *Spector v. City of New York*, 75 Civ. 5461 (S.D.N.Y.1975); *Weisberg v. City of New York*, 75 Civ. 5582 (S.D.N.Y.1975); *Velardi v. First National City Bank*, 76 Civ. 0843 (S.D.N.Y. 1976); *Manchester v. City of New York*, 77 Civ. 0990 (S.D.N.Y.1977); *Goldfarb v. City of New York*, 75 Civ. 5581 (S.D.N.Y.1975). In the *Bank of America* and *First National Bank of Boston* cases, venue for trial purposes is set forth in The National Bank Act, 12 U.S.C. § 94.

4. The City is a named defendant in *Friedlander v. City of New York*, *supra*; *Spector v. City of New York*, *supra*; *Goldfarb v. City of New York*, *supra*; *Weisberg v. City of New York*, *supra*; *Manchester v. City of New York*, *supra*.

legedly taken to preserve prevailing bond prices to allow the defendants to profitably dispose of their own holdings of City bonds. Certain of the defendants are said to have reduced their holdings in City bonds from $2.5 billion on May 1, 1974 to virtually nil by the time the prices of those bonds plummeted. Here, as in *Friedlander*, the City is alleged to have aided and abetted this conspiracy by virtue of material misrepresentations and nondisclosures to the public concerning the City's finances. Plaintiffs contend that as a result of the acts of the City defendants and the underwriter and seller defendants, the members of the class—predominately "after-market" purchasers of the City general obligation bonds—incurred substantial economic losses.

The allegations in *Goldfarb*, *Weisberg* and *Manchester* are essentially the same as those in *Friedlander* and *Spector*. The remaining cases, while not alleging securities fraud on the part of the City defendants, allege violations of § 17(a) of the Securities Act and/or § 10(b) of the Securities Exchange Act by certain of the commercial banks or brokerage firms.[5] It is undisputed that all of the conduct at issue occurred prior to the enactment of the 1975 amendments to the Securities Exchange Act.

The City and the underwriter and seller defendants move to dismiss for failure to state a claim upon which relief may be granted, Fed.R.Civ.P. 12(b)(6),[6] on the following legal theories:

(1) That transactions involving municipal securities, whether by the City, the underwriters or other sellers, are not covered by § 10(b) of the Securities Exchange Act; and, consequently, no private right of action is conferred upon a purchaser of such securities; and

(2) That while § 17(a) of the Securities Act expressly includes municipal securities and has been construed to confer enforcement rights upon the Securities Exchange Commission ("SEC") in the event of violations, it does not confer a private right of action upon an investor; and

(3) That if the antifraud provisions of the securities laws apply to municipal securities, the tenth amendment to the United States Constitution would render such provisions unconstitutional as applied to the City defendants.

In the alternative, certain of the underwriter defendants argue that if a private right of action *does* exist as to them with respect to transactions in municipal securities, it must also be implied against the City as issuer.

From a careful consideration of the 1933 and 1934 Acts (and their amendments) viewed in the light of their extensive legislative histories and the relevant case law, I conclude that the motions of the City defendants to dismiss should be granted, while those of the underwriter and seller defendants should be denied.

I. The Applicability of § 10(b) of the Securities Exchange Act to Municipal Securities and to the Underwriters and Sellers Thereof

The threshold question presented is whether the private right of action unquestionably available to a purchaser of corporate securities under § 10(b) of the 1934 Act,[7] and Rule 10b–5 promulgated thereun-

5. In one of these cases, *World Airways, Inc. v. Salomon Brothers*, 78 Civ. 0072 (S.D.N.Y.1978), the plaintiff has advised the court that it will amend its complaint to join the City as a defendant if the instant motions are denied.

6. Plaintiff World Airways has submitted a motion for partial summary judgment pursuant to Fed.R.Civ.P. 56(c). Argument on this motion has been deferred by the court until after decision on the motions to dismiss.

7. Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or any facility of any national securities exchange
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or

der,[8] is equally available to a purchaser of municipal securities. This is "basically a matter of statutory construction." *Trans-America Mortgage Advisors v. Lewis*, 444 U.S. 11, 100 S.Ct. 242, 62 L.Ed. 146 (1979).

[1, 2] The Securities Exchange Act was designed "to provide for the regulation of securities exchanges and of the over-the-counter markets . . . to prevent inequitable and unfair practices in such exchanges and markets . . ." S.Rep.No. 792, 73d Cong. 2d Sess. 1 (1934). Nevertheless, Congress, by including § 3(a)(12), 15 U.S.C. § 78c(a)(12), in the 1934 Act, clearly contemplated that, at least for some purposes, governmental securities, including those of municipalities, would be exempted from certain of its requirements. The defendants argue that the mere inclusion of § 3(a)(12) in the 1934 Act evidences a Congressional intent to exempt municipal securities from the operation of § 10(b). I reject this contention.

[3] At the time of the events in question, § 3(a)(12) defined an "exempted security" as follows:

> The term "exempted security" or "exempted securities" includes securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States; . . . securities which are direct obligations of or obligations guaranteed as to principal or interest by a State or any political subdivision thereof, or by any agency or instrumentality of a State or any political subdivision thereof, or by any municipal corporate instrumentality of one or more states; . . . and such other securities . . . as the Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, . . . exempt from the operation of any one or more provisions of this chapter which by their terms do not apply to an "exempted security" or to "exompted securities."

1934 Act, ch. 404, § 3, 48 Stat. 882. This section is strictly definitional. Whether or not a given substantive section applies to "exempted securities" is left to the express language of the particular section. In the Senate Report on the 1934 Act, the draftsmen confirm this view by noting that a "large number of the provisions in the Act expressly include 'exempted securities'".[9] In short, when Congress wanted to exclude exempted securities from a section of the Act, it knew how to do so.[10] It is significant, therefore, that the language of § 10(b) does not evidence such an intent. That section makes it unlawful for "any person . . . to use or employ, in connection with the purchase or sale of *any security* registered on a national securities exchange or any security not so registered, any mani-

appropriate in the public interest or for the protection of investors.
15 U.S.C. § 78j(b).

8. Rule 10b-5 provides:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or any facility of any national exchange,
(a) to employ any device, scheme or artifice to defraud,
(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
(c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
17 C.F.R. § 240.10b-5.

9. S.Rep.No.792, 73d Cong., 2d Sess. 14 (1934).

10. Congress expressly excluded exempted securities from the following sections by stating that those sections applied to "any securities (other than exempted securities)": § 7(a) (margin rules), 15 U.S.C. § 78g(a); § 8(a) (restrictions on borrowing by members, brokers and dealers), 15 U.S.C. § 78h(a); § 9(f) (manipulation of s[illegible]y prices), 15 U.S.C. § 78i(f); § 12(a) (registration requirements for securities), 15 U.S.C. § 78l(a); § 14(a) (proxy rules), 15 U.S.C. § 78n(a); § 15(a)(1) (registration of brokers and reporting requirements in over-the-counter markets), 15 U.S.C. § 78o(a)(1); § 16(a), (b), (c) (insider trading and reporting requirements), 15 U.S.C. § 78p(a), (b), (c).

pulative or deceptive device . . . ." (emphasis added). The Congressional intent to have § 10(b) extend to fraudulent conduct in connection with all securities in the broadest sense, including those defined in § 3(a)(12), could not be clearer. The draftsmen not only omitted reference to "exempted securities," they also specifically included both registered and unregistered securities, as well as transactions both on the national securities exchanges and in the over-the-counter market.

The legislative history of § 3(a)(12) further demonstrates that it serves only to define "exempted securities." The original draft of § 3(a)(12) expressly exempted only United States Government securities,[11] and the Federal Trade Commission was to be vested with the authority to broaden the scope of § 3(a)(12).[12] In discussing this grant of authority, the draftsmen wrote:

> A large number of provisions in the act expressly exclude "exempted securities." Thus the Commission is able to *remove from the operation of any one or more of these provisions* any securities as to which it deems them inappropriate.

H.R.Rep.No.1383, 73d Cong., 2d Sess., 17 (1934) (Emphasis added); *see also* S.Rep.No. 792, 73d Cong., 2d Sess. 14 (1934). Thus, Congress granted the Commission the authority to add other securities to the list of exempted securities, but it did not empower the Commission to exclude "exempted securities" from other sections of the Act. That Congress later expanded the definition of "exempted securities" to include those of state and municipal issuers does not alter the limited function of § 3(a)(12).

It is also clear that obvious political considerations motivated Congress to enact the exemptions it eventually provided for municipal securities in the 1933 and 1934 Acts. *Landis, The Legislative History of the Securities Act of 1933*, 28 Geo.Wash.L.Rev. 29, 39 (1959). The political, as well as economic, justifications underlying § 3(a)(12) are most visible in the Congressional hearings on the 1934 Act. Paramount among the political concerns was the impact on federal-state relations of vesting the Federal Trade Commission with the *discretionary* authority to affect the credit of a state or municipality. Senate Hearings, *supra*, at 7477. In testimony before the Senate, George B. Gibbons, a New York City municipal bond dealer, highlighted the danger of vesting such power in the Federal Trade Commission:

> State bonds and the bonds of their political subdivisions and agencies are not exempted by the provisions of this Act, and they are under the power of the Federal Trade Commission. That gives them, if they so care to use it, a very dangerous power over the financial affairs of all the states, cities, counties and political subdivisions and agencies in them; and it might be exercised to their great disadvantage.
>
> The credit of a state, or a municipality or agency within it, and its ability to finance its many needs for roads, schools, preservation of health, and so on, would be seriously crippled by the refusal of the Federal Trade Commission to exempt its bonds or by the imposing of unreasonable conditions for granting such exemptions, and cause irreparable damage and loss to both the State or municipality and to the holders of their outstanding bonds by the withdrawal of exemption in cases where it had once been granted.

11. Under the earlier versions of the bill, the Federal Trade Commission was empowered to grant additional exemptions in the public interest. *Compare* H.R.Rep.No.1383, 73d Cong., 2d Sess. 17 (1934) (House Report accompanying H.R. 9323) *with* H.R.Rep.No.1838, 73d Cong., 2d Sess. 4 (1934) (Conference Report accompanying H.R. 9323).

12. Testimony before both the House and Senate Committees shows that the draftsmen of the Act believed that the Federal Trade Commission would take up the question of exempting municipal securities. *See Hearings Before House of Representatives Committee on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720*, 73d Cong., 2d Sess. 818–24 (1934) ("House Hearings"); *Stock Exchange Practice: Hearings Before the Senate Banking and Currency Committee on S.Res. 84 and S.Res. 56 and S.Res. 97*, 73d Cong., 2d Sess. 7475–78 (1934) ("Senate Hearings").

Senate Hearings, *supra*, at 7446.[13] In fact, these very same objections prompted one member of the House Committee to note that "a real [constitutional] question" existed as to "the power of Congress to place any burden upon a state in the marketing of its bonds . . . ." House Hearings, *supra*, at 822.

An equally compelling argument was addressed to Congress detailing the economic impact of failing to include state and municipal obligations in § 3(a)(12). Numerous witnesses observed that the failure to provide a blanket exemption for municipal and state obligations, while providing such an exemption for securities of the federal government, would impose a serious economic burden on the nonexempted securities. *See, e. g.*, House Hearings, *supra*, at 721. As one witness explained to the Senate Committee:

> The inclusion of State and municipal bonds in the bill does not confer any benefit on the holders of municipal bonds nor on the municipalities issuing them. On the contrary, it imposes a very distinct hardship on both municipalities and the purchasers of their bonds and will seriously affect their value as an investment. The exemption of a municipal bond would not add to its present value, and refusing exemption would seriously impair its value.
>
> If being exempted from this bill is helpful to the United States Government bonds, certainly States and municipalities need that help also. If not being exempted would be harmful to Government bonds, certainly States and municipalities should not suffer that harm.

Senate Hearings, *supra*, at 7445. *See also id.* at 7444.[14]

It was also urged that municipal securities were simply not subject to the same "speculative abuses" as were corporate securities because: (1) there is "practically no speculation" in the municipal market; (2) the purchasers of municipal securities are large, sophisticated public institutions and corporations; and (3) the relatively small number of municipal securities made it "almost impossible to effect wash sales" and "practically impossible to sell municipal bonds short." *See* Senate Hearings, *supra*, at 7443.

[4] As this legislative history documents, the addition of municipal and state securities to the category of "exempted securities" as defined in § 3(a)(12) evidences essentially a Congressional decision to avoid the political and economic consequences of unequal treatment of federal, state and municipal securities. It does *not* reflect a legislative intent to exempt municipal securities from the provisions of § 10(b) of the 1934 Act. On the contrary, the legislative debates over the scope of the § 3(a)(12) definition of "exempt securities" compel just the opposite conclusion.

Of paramount concern to the draftsmen of the original version of § 3(a)(12)—the same individuals who drafted § 10(b)—was the protection of investors in municipal and state securities. Thus, it is quite clear from the legislative record that the draftsmen's initial omission of municipal securities from § 3(a)(12) can be explained by the fact that at the time it was drafted approximately 17,300 municipalities—about 1% of the municipalities in America—were either delinquent or in default. House Hearing, *supra*, at 822.[15] *See also* Senate Hearings, *supra*,

13. *Cf. National League of Cities v. Usery*, 426 U.S. 833, 96 S.Ct. 2465, 49 L.Ed.2d 245 (1976). Similar considerations may explain the absence of any mention of municipalities, states or the federal government in the definition of "persons" in § 3(a)(9) of the 1934 Act.

14. There were specific objections to the application to municipal securities of the proposed margin requirements, capital requirements for dealers, regulation of the over-the-counter market and prohibitions on market stabilization. *See, e. g.*, Senate Hearings, *supra*, at 6839–40, 7068–69, 7432–34, 7441–43.

15. Default had occurred in about $1,500,000,000 worth of bonds. This figure, while substantial in size, is somewhat deceptive. It represents the total dollar value of issues in which there had been some nonpayment; any delinquency caused the entire debt of that issuer to be considered in default. *See* House Hearings, *supra*, at 822; Senate Hearings, *supra*, at 7443.

at 7413. Congress was apparently convinced that those investors were entitled to the fullest possible protection with regard to these securities. Senate Hearings, *supra*, at 7477. *See also* House Hearings, *supra*, at 821, 822.

Thus, while the desire to maintain political and economic parity among governmental issuers led to the eventual inclusion of municipal securities in the definition of "exempted securities," Congressional concern for investor protection from the practices of certain *sellers* of municipal securities remained. In an exchange that suggests the reason that "exempted securities" were *not* expressly excluded from § 10(b), Senator Gore inquired:

> Is there any way that you could vest the administrative agency with the power to forewarn prospective purchasers that the bond of a certain town is a bad investment? Is there any red light at all? One of the objects of this bill is to protect the fool against his follies. I do not know whether they can do it or not, but I do not see any difference between the man that loses his money by buying municipal bonds that are no good, I do not see that he is any better off than if he put it in a railroad bond or a chewing-gum factory bond or something of that sort. He lost his money . . . .

Senate Hearings, *supra*, at 7450. In fact, evidence of fraud and misrepresentations in the sale of municipal securities to the public was frequently brought to the attention of the Senate Committee. *See* Senate Hearings, *supra*, at 232.

Finally, strong support for the view that the draftsmen of § 10(b) and § 3(a)(12) were concerned with protecting the *investor* in municipal securities may be found in the testimony of Commissioner Landis.[16] In response to Representative Pettengill's charge that municipal securities were being "overregulated" by the proposed draft of the 1934 Act, Commissioner Landis stated:

> Well, in answer to your first question, I would have to answer that first question yes, there are abuses there [in the municipal securities market]. How widespread they are, and how important they are is a pretty hard matter to guess at, . . . , and we cannot, of course, say there are no abuses in the trading of municipal securities. Unquestionably there are salesmen who trade in municipal securities, deal in them, sell them, and will not tell the purchasers that they are in default. They are not reputable salesmen, of course, but there have been things like that done, unquestionably.
>
> Furthermore, one of the things in municipal securities is that you must differentiate between general obligations of a municipality, and special obligations . . . That distinction is often not made by the salesman. It escapes the prospective purchaser of these bonds, and sometimes because the salesman wishes it to escape.

House Hearings, *supra*, at 897. Based on this legislative history, I must conclude that while municipal securities were ultimately included in the definition of "exempt securities" in § 3(a)(12), they were not thereby removed from the strictures of § 10(b) of the 1934 Act.

[5] The case law supports the existence of an implied cause of action under § 10(b) of the 1934 Act in favor of purchasers of municipal securities. The Supreme Court's decision in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971), where the underlying securities were United States Treasury bonds, firmly established a private cause of action under § 10(b) in favor of the seller of any securities—whether or not exempted under § 3(a)(12). The unanimous Court stated in broad language that "[s]ection 10(b) outlaws the use 'in connection with the purchase or sale' of any security of 'any manipulative or deceptive device or contrivance,'" 404 U.S. at 10, 92 S.Ct. at 168. In a footnote the Court added "[s]ec-

16. The Supreme Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), credited Commissioner Landis with a crucial role in the drafting of the 1934 Act.

tion 3(a)(10) of the 1934 Act defines 'security' very broadly . . . and clearly embraces Treasury bonds."[17] 404 U.S. at 10 n.6, 92 S.Ct. at 168. Thus, the *Superintendent* result demonstrates that the definition of a "security" for the purposes of § 10(b) includes all these securities enumerated in § 3(a)(10), including municipal securities.

Defendants argue that *Cannon v. University of Chicago*, 441 U.S. 677, 99 S.Ct. 1946, 60 L.Ed.2d 1946 (1979) and *Touche Ross & Co. v. Reddington*, 442 U.S. 560, 99 S.Ct. 2479, 61 L.Ed.2d 82 (1979) undermine the holding of *Superintendent of Insurance*. I reject this contention. *Cannon* recognized that although the language of § 10(b) is merely duty-creating, as opposed to right-creating, ever since "*Superintendent of Insurance*, the [Supreme] Court [has] explicitly acquiesced in the 25 year-old acceptance by the lower federal courts of 10b–5 causes of action. *See also Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196, 96 S.Ct. 1375, 1382, 47 L.Ed.2d 668; *Blue Chip Stamps v. Manor Drug*, 421 U.S. 723, 730, 95 S.Ct. 1917, 1922, 44 L.Ed.2d 539." *Cannon v. University of Chicago, supra*, at 692 n.13. *Superintendent of Insurance* "reflects the unique history of Rule 10b–5," *Cannon v. University of Chicago, supra*, at 738 (Powell, J., dissenting), and its holding is unaffected by recent decisions applying a more restrictive standard on implication of private rights of action.

[6] Other federal courts that have considered the question almost uniformly favor the implication of a private remedy under § 10(b) and Rule 10–5 on behalf of purchasers of exempted securities. *See, e. g., Shapiro v. Schwamm*, 279 F.Supp. 798 (S.D.N.Y.1968); *Texas Continental Life Insurance Co. v. Bankers Bond Co., Inc.*, 187 F.Supp. 14 (W.D.Ky.1960), *rev'd on other grounds sub nom. Texas Continental Life Insurance Co. v. Dunne*, 307 F.2d 242 (6th Cir. 1962), *settlement agreement enforced sub nom. All States Investors Inc. v. Bankers Bond Co., Inc.*, 343 F.2d 618 (6th Cir.), *cert. denied*, 382 U.S. 830, 86 S.Ct. 69, 15 L.Ed.2d 74 (1965); *Thiele v. Shields*, 131 F.Supp. 416 (S.D.N.Y.1955); *Greenwich Savings Bank v. Shields*, 131 F.Supp. 368 (S.D.N.Y.1955); *Connecticut Mutual Life Insurance Co. v. Shields*, 131 F.Supp. 368 (S.D.N.Y.1954); *Baron v. Shields*, 131 F.Supp. 370 (S.D.N.Y.1954). Moreover, courts have uniformly rejected the argument advanced here by the defendants that because the express civil liability provisions of § 12(2) of the 1933 Act, 15 U.S.C. § 77*l*(2),[18] exempt governmental securities,[19] purchasers of those se-

17. Nothing in the legislative history of the 1934 Act suggests that § 10(b) was intended to include United States Treasury bonds but to exclude municipal securities.

18. Section 12(2), 15 U.S.C. § 77*l*(2), provides:

Any person who—

(1) offers or sells a security in violation of section 77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission) and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

19. Section 3(a)(2), 15 U.S.C. § 77c(a)(2), which is almost identical to § 3(a)(12) of the 1934 Act, defines exempted securities as follows:

(a) Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

.

(2) Any security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of one or more States

curities should not be permitted to circumvent that exception by suing under § 10(b) of the 1934 Act.[20] In *Thiele v. Shields*, *supra*, the court explained:

> That Congress intended to exempt a seller of municipal bonds from liability for failure to prove that he exercised reasonable care in investigating the truth of a representation is not inconsistent with the subjection to civil liability of the same seller after the purchaser proves that he knowingly misrepresented a fact.

131 F.Supp. at 419.[21] *Accord, Baron v. Commercial Industrial Bank* [1979] Fed.Sec. L.Rep. (CCH) ¶ 96,826 (S.D.N.Y.1979); *Connecticut Mutual Life Insurance Co. v. Shields, supra; Greenwich Savings Bank v. Shields, supra; Baron v. Shields, supra; compare* 3 Loss *Securities Regulation* 1778–91 (2d ed. 1961) and 6 Loss *Securities Regulation* 3917 (1969) *with* 1A Bromberg *Securities Law: Fraud—SEC Rule 10b-5* § 2-4(2)(3) (1977);[22] *cf. Weber v. C. M. P. Corp.*,

or territories, or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing; . . ."

20. The plaintiff purchaser suing under § 10(b), as opposed to § 12(2), avoids the restrictive provisions of the 1933 Act. Specifically, he circumvents the one year statute of limitations imposed by § 13 and the rescission measure of damages provided in § 12(2). However, as discussed *infra*, the plaintiff-purchaser must bear the much heavier burden of proving scienter when suing under § 10(b), and he loses the advantage of the 1933 Act requirement that the defendant carry the burden of going forward with his "due diligence" defense. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976). *See generally* note 23, *supra*.

21. *Thiele* relied on the rationale of *Kardon v. National Gypsum*, 69 F.Supp. 512 (E.D.Pa. 1946) and *Fischman v. Raytheon Manufacturing Co.*, 188 F.2d 783 (2d Cir. 1951), i. e., a tort theory of recovery, as a basis for implying a private cause of action under § 10(b). Defendants argue that recent decisions rejecting the *Kardon-Fischman* rationale effectively overrule *Thiele* and its progeny. However, given the Supreme Court's acknowledgment of the existence of a § 10(b) cause of action, *Cannon v. University of Chicago*, *supra*, at 1955 n.13, as well as the acceptance of the *Kardon-Fischman* rationale in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975), and *Ernst & Ernst v. Hochfelder*, *supra*, the defendant's position must be rejected. *See, Ross v. A. H. Robbins Co.*, 607 F.2d 545 (2d Cir. 1979) (a post-*Cannon* affirmation of the applicability of the *Kardon-Fischman* rationale in the context of § 10(b)).

22. Professor Loss points out the anomalies created by the implication of a private right of action under § 10(b), but fails to acknowledge the anomalies created by other possible interpretations. The Ninth Circuit in *Ellis v. Carter*, 291 F.2d 270, 272-74 (9th Cir. 1961), sets forth four possible constructions of § 10(b) and explains the difficulties presented by each one:

> (1) As permitting no civil actions to either buyer or seller on the ground that the 1933 and 1934 acts were too closely drafted to permit the inference of any private remedies in addition to those expressly provided in sections 11 and 12 of the 1933 act, and sections 9(e), 16(b) and 18(a) of the 1934 act. But under such a construction defrauded sellers are given no civil remedy under either act, which seems inconsistent with the all-embracing scope of the legislation and requires that an unexplained distinction be drawn between buyers and sellers.
>
> (2) As permitting sellers but not buyers to sue under the rule, thereby giving both buyers and sellers a civil remedy but limiting that of buyers to the remedies provided in the 1933 act. But this seems inconsistent with the fact that section 10(b) and rule 10b-5 are expressly applicable to buyers as well as sellers. Moreover, there seems to be no good reason why Congress would want to restrict buyers to the limited remedies provided in the 1933 act, while giving sellers an unrestricted civil remedy. The converse inference—drawn by reading the restrictions of the 1933 act which apply only to buyers as applicable also to sellers under the 1934 act—would constitute judicial rewriting which even appellees concede would be too gross.
>
> (3) As permitting buyers as well as sellers to sue under the 1934 act, but to make buyers' actions thereunder subject to the same restrictions as provided for them in the 1933 act. This avoids the anomaly of giving the buyer a less restricted remedy under the 1934 act than he has under the 1933 act. In effect, however, it is the same as giving him no right under the 1934 act, leaving an unexplained distinction between buyers and sellers as noted above.
>
> (4) As permitting buyers as well as sellers to sue under section 10(b) and rule 10b-5 without any distinction whatever, free of the restrictions imposed under the 1933 act.

242 F.Supp. 321 (S.D.N.Y.1965).[22]

In the present litigation, the plaintiffs allege that the commercial banks and brokerage firms engaged in a conspiracy to defraud the purchasers of New York City bonds and notes. The language and legislative history of § 10(b), as well as the legal precedents recognizing an implied private remedy on behalf of the defrauded purchasers, support the conclusion that § 10(b) applies to municipal securities and to the underwriters who sell them. The underwriter and seller defendants' motion to dismiss the § 10(b) cause of action as to them is accordingly denied.

II. *The Applicability of § 10(b) to Municipal Issuers: The City of New York and its Officials*

[7] On its motions to dismiss, the City first contends that § 10(b) does not apply to municipalities. Although I have concluded that § 10(b) extends to *transactions* in municipal securities, I also conclude that as "person" is defined in the 1934 Act, liability under § 10(b) does not reach a municipal issuer.

Section 10(b), and Rule 10b-5 promulgated thereunder, make it unlawful for "any person" to engage in fraud in the sale or purchase of "any security." At the time of

> This construction has the virtue of giving both buyers and sellers a civil remedy and giving buyers the same unrestricted remedy which is given to sellers, no reason being shown why Congress should have intended to treat them differently. But this construction is saying in effect that the procedural restrictions which Congress carefully provided in the 1933 act with regard to a buyer's civil remedy were completely nullified or ignored by Congress a year later in giving buyers an unrestricted civil remedy.
>
> In *Matheson* [v. *Armbrust*, 284 F.2d 670 (9th Cir. 1960)] we adopted the fourth of these alternatives. We now adhere to that determination. Recognizing the anomaly inherent therein, as noted above, we consider it the most acceptable of the four possible alternatives. It gives controlling weight to what seems to have been the dominant policy of Congress to provide complete and effective sanctions, public and private, with respect to the duties and obligations imposed under the two acts. It requires no variance in procedures under the 1934 act as between buyer and seller, no reason appearing why Congress would have wanted the procedures to be different. While it assumes that Congress in 1934 undid what it carefully did in 1933, it avoids judicial rewriting of the 1934 act to include procedural provisions which appear only in the 1933 act. As between two acts which deal with the problem, it permits the most recent enactment to govern. . . ."

Although the court goes on to conclude that a cause of action under § 10(b) could be sustained without a showing of *scienter*, a view repudiated by the Supreme Court in *Ernst & Ernst v. Hochfelder*, supra, the conclusion that purchasers should be entitled to sue under § 10(b) is consistent in all other respects with decisions in this circuit. *See, e. g., SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 864 (2d Cir. 1968), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976, 89 S.Ct. 1454, 22 L.Ed.2d 756 (1969) (Friendly, J. concurring); *Forman v. Community Services Inc.*, 500 F.2d 1246 (2d Cir. 1974) *rev'd on other grounds sub nom. United Housing Foundation v. Forman*, 421 U.S. 837, 95 S.Ct. 2051, 44 L.Ed.2d 621 (1975). *Cf. Weber v. C. M. P. Corp.*, 242 F.Supp. 321 (S.D.N.Y.1965) (criticizing the *Ellis* court for not requiring *scienter* in § 10(b) actions).

22. In *Blue Chip Stamps v. Manor Drug Stores*, *supra*, the Court left open

> the question of whether an implied action under § 10(b) of the 1934 Act and Rule 10b-5 will lie for actions made a violation of the 1933 Act and the subject of express civil remedies under the 1933 Act. Compare *Rosenberg v. Globe Aircraft Corp.*, 80 F.Supp. 123 (E.D.Pa.1948), with *Thiele v. Shields*, 131 F.Supp. 416 (S.D.N.Y.1955).

Id. 421 U.S. at 752 n.15, 95 S.Ct. at 1933. Since *Thiele* the lower federal courts have unanimously recognized an implied cause of action under § 10(b) in favor of purchasers alleging fraud, as opposed to mere negligent misrepresentation, in the sale of securities. The *Rosenberg* decision, which denied the more liberal venue provision available under § 10(b) to a plaintiff whose allegations fell within the express provisions of the 1933 Act, has not been followed in this circuit. *See generally* 1 Bromberg, *Securities Law: Fraud—SEC Rule 10b-5* § 2.4(2) n.76 ("*Rosenberg v. Globe Aircraft Corp.* . . . can no longer be regarded as valid."). It is inconceivable that Congress intended to subject the defrauding party in the initial distribution to the rescission measure of damages available under § 12(2) of the 1933 Act, while subjecting the wrongdoer in the aftermarket to the market measure of damages under § 10(b) of the 1934 Act.

the events in suit, and prior to its amendment on June 4, 1975, § 3(a)(9) of the 1934 Act defined "person" as follows:

> The term "person" means an individual, a corporation, a partnership, an association, a joint-stock company, a business trust, or an unincorporated organization.

1934 Act, ch. 404, § 3(a)(9), 48 Stat. 882. This definition of "person" does not, by its terms, apply to municipalities, states or the federal government.[24] Nor can such entities be included by implication. This is clear from a comparison of § 3(a)(9) of the 1934 Act with § 2(2) of the 1933 Act, 15 U.S.C. § 77b(2), in which Congress expressly included governmental entities:

> The term 'person' means an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, *or a government or political subdivision thereof.*[25]

(Emphasis added.) Moreover, in June of 1975, Congress found it necessary to amend § 3(a)(9) to expressly include a "government, or political subdivision, agency, or instrumentality of a government." Pub.L. No.94-29, § 3, 89 Stat. 97 (1975), 15 U.S.C. § 78c(a)(9) (1977 Supp.). Thus, the omission of express reference to these entities in § 3(a)(9) of the 1934 Act reflects a decision *not* to include governments within that section.

[8] While the plaintiffs and certain defendants argue, nonetheless, that the difference between the definition of "person" in the 1934 Act and the 1933 Act are merely "stylistic," the legislative history and statutory framework of the securities laws contradict this view. Regulation of governmental instrumentalities was carefully avoided in both the 1933 and 1934 Acts. Congressional reluctance to subject governmental issuers to the civil liability provisions of the securities laws is clearly expressed in the House Report accompanying the 1933 Act. There, the House Committee, explaining the reasons for the § 3(a)(2) exemption for governmental issuers, stated:

> Paragraph (2) exempts United States, Territorial and State obligations, or obligations of any political subdivision of these governmental units. The term "political subdivision" carries with it the exemption of such securities as county, town, or municipal obligations, as well as school district, drainage district, . . .
> The line drawn by the expression 'political subdivision' corresponds generally with the line drawn by the courts as to what obligations of States their units and instrumentalities created by them, are exempted from Federal taxation. *By such a delineation, any constitutional difficulties that might arise with reference to the inclusion of state and municipal obligations are avoided.*

H.R.Rep.No.85, 73d Cong., 1st Sess. 14 (accompanying H.R. 5480) (emphasis added). These same constitutional limitations, real or imagined, upon Congress's authority to subject governmental issuers to the regulatory scheme were an obvious factor leading to the exemption of such issuers from § 5 and § 12(2) of the 1933 Act.[26] One year

24. Although the plaintiffs and underwriter defendants argue that the term "corporation" in § 3(a)(9) covers municipal corporations, that position is wholly inconsistent with the legislative history of the 1934 Act. As discussed above, the draftsmen of the 1934 Act were extremely concerned with maintaining a balanced treatment of governmental entities. The statutory construction urged by these parties would impute to Congress an intent to subject municipalities to § 10(b) liability, while simultaneously excluding states and the federal government from those provisions. This construction is simply unsupportable.

25. By virtue of 17 C.F.R. § 240-01(b), the definition of "person" in § 3(a)(9) applies to Rule 10b-5, 17 C.F.R. § 240.10b-5.

26. Section 17(a), 15 U.S.C. § 77q(a), is the only provision of the 1933 Act to which the § 3(a)(2) exemption for governmental issuers does not apply. It provides that:

> (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation in interstate commerce or by the use of the mails, directly or indirectly—
> (1) to employ any device, scheme, or artifice to defraud, or
> (2) to obtain money or property by means of any untrue statement of a material fact or

later, after further hearings on the constitutional, political and economic impact of regulations affecting governmental issuers, Congress continued to be of the same view and exempted transactions in government obligations from certain provisions of the 1934 Act.[27] The definition of "person" in the 1934 Act, operating as it does to remove governmental instrumentalities from the civil liability provisions of § 10(b), simply furthers the Congressional policy announced in the 1933 Act.

[9] This analysis is not inconsistent with my earlier conclusion that Congress intended underwriters and sellers to be liable under § 10(b) for their own independent fraudulent conduct in connection with municipal securities. The underwriter defendants argue, by analogy, that since § 12(2) of the 1933 Act exempts both municipal issuers and underwriters, any exemption for municipal issuers under § 10(b) of the 1934 Act necessarily extends to underwriters. The underwriters cannot claim a "derivative immunity" such as that afforded underwriters under § 12(2) of the 1933 Act. It is true that the Congressional protection afforded governmental issuers under § 12(2) similarly shields underwriters from liability for negligent misrepresentations or omissions. However, § 12(2) exhibits nothing more than a Congressional intent not to impose the disclosure burden of § 5 of the 1933 Act on governmental issuers, and not to shift that responsibility to the underwriters of governmental obligations. By contrast, in § 10(b) of the 1934 Act, Congress clearly intended to differentiate between the governmental issuer on the one hand, and underwriters and sellers on the other. Although the debate on the 1934 Act reveals no evidence of a Congressional concern with fraud on the part of governmental issuers, the same cannot be said of Congress' attitude toward others doing business in municipal securities. As observed earlier in the discussion of the scope of § 10(b), Commissioner Landis testified before Congress that some sellers of municipal bonds had defrauded the investing public. House Hearings *supra*, at 897.[28] Congress's decision to subject underwriters and sellers of municipal securities to civil liability under § 10(b) for their own fraudulent conduct understandably followed.

[10] Next, it has been argued that Congress, by redefining "person" to include a municipality in the 1975 Amendments to 1934 Acts, merely made explicit what had all along been the case. The legislative history, however, compels the opposite conclusion.[29] Although Congress sought to establish a regulatory scheme for the municipal securities *market* by the adoption of the 1975 amendments,[30] what Commissioner Landis referred to as "obvious political reasons" again led Congress to regulate municipal securities dealers but to exempt the municipalities themselves. Concern that "even if regulation were limited to dealers, it would inevitably have consequences for

any omission to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

This section does no more than provide a basis for criminal prosecution and SEC injunctive proceedings. *See* discussion of § 17(a) *infra*. The constitutionality of SEC enforcement actions against municipal issuers pursuant to this section has not yet been conclusively established. *See City of Philadelphia v. SEC*, 434 F.Supp. 281 (E.D.Pa.1977), *appeal dismissed for want of jurisdiction*, 434 U.S. 1003, 98 S.Ct. 707, 54 L.Ed.2d 746 (1978).

27. *See* note 10, *supra*.

28. *See* text accompanying notes 8 to 17 *supra*.

29. The legislative history of the 1975 Amendments does not reveal what was on the minds of legislators in 1934. At best, it is evidence of what the 1975 Congress understood about the operation of the 1934 Act.

30. The 1975 Amendments added, among other things, provisions for the establishment of the Municipal Securities Rulemaking Board, a regulatory mechanism for dealers in municipal securities. *See* § 15B of the 1934 Act, 15 U.S.C. § 78o–4.

issuers." [31] prompted the adoption of the Tower Amendments. These amendments attempted to limit the "collateral effect" of the 1975 Amendments [32] on issuers in the following way:

> (d)(1) Neither the Commission nor the Board is authorized under this chapter, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.
>
> (2) The Board is not authorized under this chapter to require any issuer of municipal securities, directly or indirectly through a municipal securities broker or municipal securities dealer or otherwise, to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer . . . .

15 U.S.C. § 78o-4(d). The aim of the Tower Amendments was to insure that the 1934 Act (as amended) would not "tamper in any way with prerogatives of state and local governments in their sale of securities." 121 Cong.Rec. 6188 (1975) (remarks of Senator Williams). Thus, in 1975 Congress merely ratified the approach taken in 1934 with respect to municipal securities. It chose, again, for possibly "obvious political reasons," to exempt municipalities themselves from regulation while subjecting others in the municipal securities market to the Act's regulatory scheme.

The legislative history of the 1975 Amendments to the Exchange Act is not silent on the question of the applicability of the antifraud provisions of the securities laws to municipal securities.[33] However, as the following comment from the Senate Report indicates, the record is somewhat ambiguous:

> The Committee is mindful of the historical relationship between the federal securities laws and issuers of municipal securities. Apart from the general antifraud provisions, municipal securities are exempt from all substantive requirements.

S.Rep.No.94-75 at 44, U.S.Code Cong. & Admin.News 1975, p. 221. *See also id.* at

31. Doty & Petersen, *The Federal Securities Laws and Transactions in Municipal Securities*, 71 N.W.U.L.Rev. 283, 345 (1976) (hereinafter "*Transactions in Municipal Securities*").

32. S.Rep.No.94-75, 94th Cong., 1st Sess. 44 (1975), *reprinted in* [1975] U.S.Code Cong. & Admin.News, pp. 179, 222.

33. Many commentators, including those relied upon by the movants, have concluded that the 1975 Amendments subject municipal issuers to antifraud liability under § 10(b) for the first time. *See* Schwartz, *Municipal Bonds and the Securities Laws: Do Investors Have An Implied Private Remedy*, 7 Securities Regulation Law Journal 119 (1979); Note, *Federal Securities Fraud Liability and Municipal Issuers: Implication of National League of Cities v. Usery*, 77 Colum.L.Rev. 1064 (1977); Doty & Petersen, *Transactions in Municipal Securities*, *supra*.

In 1976 Senator Williams introduced S. 2969 to resolve the issue of civil liability of municipal issuers and underwriters. In his testimony on that bill, Professor Doty offered the following explanation of the effect (and purpose) of the 1975 Amendments:

> It is important to realize that Rule 10b-5 became explicitly applicable to municipal securities issuers only last year. The Securities Acts Amendments of 1975 added to the definition of "person" a "government, or political subdivision, agency, or instrumentality of a government." This definition is incorporated into Rule 10b-5 by Commission Rule 0-1(b). The Commission evidently takes the position that this amendment was only for clarifying purposes, since it was ignored in Securities Exchange Act Release No. 11876 (November 26, 1975), in which the Commission referred to past applicability of Rule 10b-5.
>
> This position may or may not be accurate. The Committee Report on S. 249 mentions the change as an amendment, but does not say it is only for clarification. S.Rep.No.75, 94th Cong., 1st Sess. 90 (1975). For years, the definition of "person" included "corporations," but said nothing of "municipal corporations." This is significant. As indicated below in the discussion of sovereign immunity issues, the Supreme Court has required specific reference to state and local governments before holding them subject to other legislation.

Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs on S. 2969 and S. 2574, 94th Cong., 2d Sess. 311 (1976).

45.[34] First, this statement merely confirms that § 10(b) was intended to cover transactions in municipal securities. Second, as discussed *infra*, this statement accurately reflects the fact that § 17(a) expressly subjected municipal issuers to the injunctive and criminal provisions of the 1933 Act. *See Proposed Amendments to the Securities Exchange Act of 1934: Hearings on S. 249 Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs*, 94th Cong., 1st Sess. 476–79 (1975). Whatever effect the 1975 Amendments may have had on the amenability of governmental issuers to civil liability under § 10(b) in future lawsuits,[35] nothing in the legislative history of those Amendments indicates that prior to their enactment § 10(b) was meant to give rise to a private cause of action against a governmental issuer.

Contrary to the plaintiffs' contention, the Second Circuit in *Forman v. Community Services, Inc.*, 500 F.2d 1246 (2d Cir. 1974), *rev'd on other grounds sub nom. United Housing Foundation v. Forman*, 421 U.S. 837, 95 S.Ct. 2051, 44 L.Ed.2d 621 (1975) did not have before it the question presented here. In *Forman*, the plaintiffs, purchasers of shares in a New York State financed cooperative apartment, brought suit against several corporate defendants under § 10(b) of the 1934 Act and § 17(a) of the 1933 Act. Significantly, the plaintiffs also sought to recover damages from the New York State Housing Finance Agency and the State of New York alleging violations of 42 U.S.C. § 1983 arising out of the same conduct which gave rise to the § 10(b) claims asserted against the other defendants. Thus, the *Forman* court had no occasion to consider whether § 10(b) applied directly to governmental issuers.[36]

While *Forman* did not have the question before it, courts that have considered whether § 10(b) extends to municipalities agree that it does not. Decisions in the Second Circuit and in this district have acknowledged the fact that the definition of "person" in § 3(a)(9) of the 1934 Act did not include municipalities. In *Monell v. Department of Social Services of the City of New York*, 532 F.2d 259 (2d Cir. 1976), *rev'd on other grounds*, 436 U.S. 658, 98 S.Ct. 2018, 56 L.Ed.2d 611 (1978) the court, in a footnote, observed:

> [T]he definition of "person" in § 3(a)(9) of the Securities Exchange Act of 1934 did not include governmental agencies until the 1975 amendments of § 3(a)(9) . . .

34. A year after the passage of the 1975 Amendments there was still debate over whether those amendments did anything other than clarify the SEC's authority to investigate municipal issuers. *See Hearings Before the Subcommittee on Consumer Protection and Finance of the House of Representatives Committee on Interstate and Foreign Commerce on H.R. 15205, H.R. 10523, H.R. 10530, H.R. 10606 and H.R. 11534*, 94th Cong., 2d Sess. 26 (1976) (Statement of SEC Commissioner Philip A. Loomis, Jr.); *Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs on S. 2969 and S. 2574*, 94th Cong., 2d Sess. 18, 23–23 (1976) (Statement of SEC Chairman Hills). *See also* note 33, *supra*. *Cf.* SEC Release No. 34–11876 (November 26, 1975).

35. This court also need not decide whether the 1975 Amendments to § 3(a)(9) of the 1934 Act reflect a Congressional intent to subject state and local governments to federal securities regulation. *Cf. Edelman v. Jordan*, 415 U.S. 651, 94 S.Ct. 1347, 39 L.Ed.2d 662 (1974); *Employees v. Department of Public Health & Welfare*, 411 U.S. 279, 93 S.Ct. 1614, 36 L.Ed.2d 251 (1973). *See* Testimony of Professor Doty, note 34, *supra*.

36. The *Forman* court did, however, reject the State's attempt to interpose the doctrine of sovereign immunity as a bar to a claim against it arising out of the sale of securities. 500 F.2d at 1256. The court supports its conclusion that New York State had waived its sovereign immunity by referring to the legislative history of the 1933 Act. 500 F.2d at 1257. The section referred to by the court, H.R.Rep.No.85, 73d Cong., 1st Sess. 11 (1934), merely noted that the term "person" in the 1933 Act is broad enough to embrace states and local governments and their instrumentalities. That section of the House Report has nothing whatsoever to do with the civil liability provisions of the 1933 Act, which expressly exclude governmental issuers. It was undoubtedly selected by the *Forman* court only to bolster its argument that, for certain purposes, Congress intended the regulatory scheme to include governmental issuers.

582 F.2d at 263 n.8. Two recent district courts expressed the same view.[37] In *Greenspan v. Crosbie* [1976–1977 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 95,780 (S.D. N.Y.1976), the court dismissed a lawsuit brought under § 10(b) by the sellers and purchasers of the stock of a Canadian company against the Province of Newfoundland and Labrador, and the three highest officials of that province. While a suggestion of immunity filed by the State Department removed the individual defendants, the court dismissed the government defendants for lack of subject matter jurisdiction. After explaining that governments were not "persons" within the meaning of § 3(a)(9), the court observed:

> . . . it is clear that Congress intended to exclude governments from its definition of "persons" in the 1934 Act. It is significant that the earlier Securities Act of 1933 defines 'person' as '. . . a government or political subdivision thereof.' 15 U.S.C. § 77b(2). The definition in the 1934 Act virtually parallels the language, with the important exception that governments are excluded. Congress obviously intended to exclude governments from liability for violation of the 1934 Act.

Id. at 90,827. According to the *Greenspan* court, the language of § 3(a)(9) is "clear and unambiguous" in not covering governments. Any other interpretation of § 3(a)(9) would contradict its plain meaning.

An identical interpretation of § 3(a)(9) was reached in *In re Equity Funding Corp. of America Securities Litigation*, 416 F.Supp. 161, 196 (C.D.Cal.1976). There the plaintiffs asserted claims under § 10(b) against the states of California and Illinois and various state administrative agencies and officials. Those defendants were charged with aiding and abetting other defendants in the commission of securities fraud. After reaching the conclusion that the definition of person in § 3(a)(9) did not include states or their agencies, the court explained:

> It could hardly bo argued that 'aider and abettor' liability can be imposed under § 10(b) on entities not within the scope of principal liability under the statute, because not 'persons' under § 3(a)(9).

Id. at 198. The view of the *Equity Funding* court is unexceptionable. The decisions in *Greenspan* and *Equity Funding*, as well as the court's reading of § 3(a)(9) in *Monell*, are in agreement with this court's view that the draftsmen of § 3(a)(9) did not intend to include governments—municipal, state, federal or foreign—within the definition of "person."

Finally, this court need not decide whether the 1975 Amendments had the effect of subjecting municipalities to the civil liability provisions of the 1934 Act. In fact, testimony before Congress a year later suggests that the 1975 Amendments were intended to resolve any question as to the SEC's authority to act with respect to governmental issuers. *Cf. City of Philadelphia v. SEC, supra.* It is significant that the same Congress that adopted the 1975 Amendments, one year later was unable to adopt—or even report out of committee—a bill that would have provided for express civil liability in connection with municipal securities. *See Municipal Securities Full Disclosure Act of 1976: Hearings Before the House of Representatives Subcommittee on Consumer Protection and Finance, supra.* Congress apparently felt that grave political and constitutional consequences flowed from subjecting the day-to-day conduct of municipal officials to the scrutiny of the federal securities laws. For example, exposing the mayor of a city to strict antifraud liability under § 10(b) for otherwise

37. Earlier decisions holding that § 10(b) applied to transactions in municipal securities did not consider whether § 3(a)(9) included state or local governments. For example, neither *Baron v. Shields, supra*, nor *Thiele v. Shields, supra*, even recites the definition of "person" in § 3(a)(9). Those cases cannot be said to have settled the meaning of "person" for § 10(b) purposes. Moreover, in *Thiele*, the governmental issuer was not a named defendant.

general remarks made during an after-dinner speech to constituents would be highly questionable, and would fundamentally alter the relationship between elected officials and the electorate. In my opinion, interjection of the federal securities laws into clearly political affairs of local government would represent an unwarranted intrusion into the political life of the community.

[11] Given the foregoing, the City of New York cannot be held liable under § 10(b) of the 1934 Act either as a principal or as an aider and abettor, and the complaints against it, to the extent they are based on § 10(b), are dismissed. Finally, since the complaints allege that Mayor Beame and Comptroller Goldin acted solely within their official capacities,[28] they cannot be held individually liable under § 10(b), and the complaints as to them are dismissed.

III. *§ 17(a) Claim Against the City of New York*

The plaintiffs argue that, even if § 10(b) does not apply to a municipality, a private cause of action against the City exists under § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a). To resolve this question, one must examine the statutory framework of the 1933 Act, the legislative history of § 17(a), and the relevant case law. *See Cannon, supra*, and *Reddington, supra*. On the basis of an analysis of those sources, I conclude that the plaintiffs' complaint against the City under § 17(a) must also be dismissed.[29]

[12] Section 17(a) of the 1933 Act must be viewed together with the express civil liability provisions of § 11 and § 12(2) of the same Act. Section 11 deals only with noncompliance or faulty compliance with the registration and prospectus requirements of § 5. By contrast, § 12(2) of the 1933 Act, which expressly excludes exempted securities from its coverage, specifically provides a private remedy to a defrauded investor. Given the interrelationship of these sections, Congress probably did not intend § 17(a) to furnish defrauded investors with a further basis for asserting civil liability. *See* Douglas & Bates, *Federal Securities Act*, 43 Yale L.J. 171 (1934) ("Section 17 probably does not enlarge civil remedies of purchasers . . . since Section 11 and 12 expressly state the remedies which are available"); 3 Loss, *Securities Regulation* 1785 (2d ed. 1966); Jennings & Marsh, *Securities Regulation* 863 (4th ed. 1977).

This interpretation of the structure of the 1933 Act, and the role of § 17(a) in that framework, is supported by its legislative history. First, the House Report on the 1933 Act clearly states under the heading, "Civil Liabilities" that "sections 11 and 12 create and define the civil liabilities imposed by the act and the machinery for their enforcement which renders them practically valuable." H.R.Rep.No.85, 73d Cong., 1st Sess. 9 (1933). Nowhere in that discussion is § 17(a) mentioned. Second, § 17(a) appears to have been intended for a wholly different function, explained by one leading commentater as follows:

> "[A] reading of [§ 17(a)] in light of the entire Act leaves no doubt but that violations of its provisions give rise only to a liability to be restrained by injunctive action or, if willfully done, to a liability to be punished criminally."

Landis, *Liability Sections of Securities Act*, 18 American Accountant, 330, 331 (1933). The same view was expressed by Judge Friendly in *SEC v. Texas Gulf & Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968), *cert. denied sub nom. Coates v. SEC*, 394 U.S.

28. The allegations in these complaints do not suggest that either of these individual defendants "acted either outside the scope of his respective office, or, if within the scope, acted in an arbitrary manner, grossly abusing the lawful power of his office." *Scheuer v. Rhodes*, 416 U.S. 232, 235, 94 S.Ct. 1683, 1686, 40 L.Ed.2d 90 (1974).

29. The text of § 17(a) of the 1933 Act is set forth in note 26, *supra*.

976, 89 S.Ct. 1454, 22 L.Ed.2d 756 (1969) (Friendly, J. concurring), where he observed that there was "unanimity among the commentators" that § 17(a) of the 1933 Act "was intended only to afford a basis for injunctive relief and, on a proper showing, for criminal liability . . .." While the SEC has expressed the view that § 17(a) grants it the authority to investigate municipal issuers, *see* SEC Release No. 34–11876 (November 26, 1975); *see generally* note 34, *supra* and accompanying text, neither the legislative history nor the statutory language of § 17(a) supports the implication of a private cause of action with respect to municipal issuers.

Plaintiffs urge that *Kirshner v. U. S.*, 603 F.2d 234 (2d Cir. 1978), *rehearing denied*, No. 77–6104 (2d Cir. July 18, 1979), *cert. denied sub nom. Goldberg v. Kirshner*, 444 U.S. 995, 100 S.Ct. 531, 62 L.Ed.2d 426 (1979) has established a "naked § 17(a)" cause of action. *See Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028 (2d Cir. 1979), *as amended*, No. 79–7150 (2d Cir. January 14, 1980). In *Kirshner*, the Court of Appeals for the Second Circuit recently held that the plaintiff, a beneficiary of a pension fund, could sue the trustees of that fund under both § 10(b) and § 17(a). In upholding the § 17(a) claim, the court noted that "there [is] little practical point in denying the existence of an action under § 17(a) once it is established that an aggrieved buyer has a private action under § 10(b) of the 1934 Act." *Id.* at 241, *citing SEC v. Texas Gulf Sulphur Co.*, *supra*, at 867 (Friendly, J. concurring). However, since as I perceive it, Congress did *not* intend to confer a private cause of action under § 10(b) against a municipal issuer, *see supra*, notes 24 to 35 and accompanying text, Congress certainly did not intend to provide such a remedy under § 17(a) alone. Consequently, I deem it inappropriate to imply a private cause of action against municipal issuers under § 17(a).[40]

The question being elsewhere undecided, and now squarely presented, I conclude for the reasons stated above that a private right of action against municipal issuers does not exist under § 17(a) of the 1933 Act, and the plaintiffs' claims against the City and its officials based thereon are dismissed.

IV. *The Pendent State Law Claims*

[13] Notwithstanding that the plaintiffs' federal securities law claims against the City defendants must fall, the question remains as to whether there is pendent jurisdiction over the city defendants with respect to the plaintiffs' common law fraud claims. This raises the "subtle and complex" issue presented in *Aldinger v. Howard*, 427 U.S. 1, 96 S.Ct. 2413, 49 L.Ed.2d 276 (1976), of "whether the doctrine of pendent jurisdiction extends to confer jurisdiction over a party as to whom no independent basis of federal jurisdiction exists."

40. The City defendants strenuously argue, in the alternative, that, even if § 10(b) applies to municipalities, the tenth amendment, U.S. Const. amend. X, would render that section unconstitutional as applied to the City.. *See National League of Cities v. Usery*, 426 U.S. 833, 96 S.Ct. 2465, 49 L.Ed.2d 245 (1976). *See generally* Note, *Federal Securities Fraud Liability and Municipal Issuers: Implications of National League of Cities v. Usery*, 77 Colum.L. Rev. 1064 (1977). *Compare Amersbach v. City of Cleveland*, 598 F.2d 1033 (6th Cir. 1979) *with Friends of the Earth v. Carey*, 552 F.2d 25 (2d Cir.), *cert. denied*, 434 U.S. 902, 98 S.Ct. 296, 54 L.Ed.2d 188 (1977); *California v. Blumenthal*, 457 F.Supp. 1309 (E.D.Cal.1978); *Colorado v. Veterans Administration*, 430 F.Supp. 551 (D.Colo.1977), *aff'd*, 602 F.2d 926 (10th Cir. 1979). This raises the difficult issue of whether it would be unconstitutional to limit the prerogatives of municipal officers by subjecting them to liability under § 10(b) with respect to statements made to the general public during a time of crisis. This court need not decide these constitutional questions since a statutory interpretation of § 10(b) requires dismissal of this action against the City defendants.

41. In *Aldinger*, the Supreme Court followed *Monroe v. Pape*, 365 U.S. 167, 81 S.Ct. 473, 5 L.Ed.2d 492 (1961) which held that local governments were not "persons" subject to suit under § 1983. However, *Monroe v. Pape* was subsequently overruled by *Monell v. New*

Id. at 2–3, 96 S.Ct. at 2415. I conclude that this court lacks the power in this case to adjudicate state law claims against a party not otherwise subject to federal jurisdiction.

In *Aldinger*, the plaintiff commenced an action in federal court against Spokane County and various county officials. In addition to a cause of action under Section 1983 of the Civil Rights Act of 1871, 42 U.S.C. § 1983, the complaint alleged common law tort claims. The court held that since the county was not subject to suit under 42 U.S.C. § 1983, the state law claims would have to be dismissed as well.[41] The court pointed out that the scope of the federal courts' subject matter jurisdiction are defined not only by the language of Article III of the Constitution, but by the "deductions which may be drawn from congressional statutes as to whether Congress wanted to grant this sort of jurisdiction to federal courts." *Id.* at 17, 96 S.Ct. at 2421. Thus, great emphasis was placed on the fact that Congress had excluded counties from liability under § 1983 by not including them in the statute's definition of "persons":

> Parties such as counties, whom Congress excluded from liability in § 1983, and thereby by reference in the grant of jurisdiction under § 1343(3), can argue with a great deal of force that the scope of that "civil action" over which the district courts have been given statutory jurisdiction should not be so broadly read as to bring them back within that power merely because the facts also give rise to an ordinary civil action against them under state law.

Id. In furtherance of this legislative intent, the Court concluded that the plaintiffs' state law claims against the county could not be joined with its federal claims against other parties.[42] In essence, the Court held that pendent jurisdiction could not be used to bring local governments back into the very cases from which the substantive legislation had excluded them.

[14, 15] This analysis is obviously applicable here. As discussed earlier, Congress excluded cities from the scope of § 10(b) of the Exchange Act and Rule 10b–5. Section 27 of the 1934 Act confers jurisdiction over "actions at law brought to enforce liability or duty created by this chapter or the rules and regulations thereunder." 15 U.S.C. § 78aa. The exclusion of cities from liability under the substantive provisions of the Act evidences a Congressional intent to withhold federal court jurisdiction over actions for securities fraud under state law. I deem it inappropriate, given the principles of *Aldinger*, to hold the City defendants on a pendent jurisdiction theory in the very actions from which Congress has excluded

York Dept. of Social Services, 436 U.S. 658, 98 S.Ct. 2018, 56 L.Ed.2d 611 (1978). In *Monell*, after reexamining the legislative history of § 1983, the Court concluded that Congress had intended to subject municipalities to suit under certain circumstances. This conclusion undermines the holding of *Aldinger* to the extent that municipalities are no longer wholly immune from suit under § 1983. Nevertheless, the validity of the holding in *Aldinger* as to pendent party jurisdiction remains intact. As the court stated in *Owen Equipment & Erection Co. v. Kroger*, 437 U.S. 365, 98 S.Ct. 2396, 57 L.Ed.2d 274 (1978), "*Monell* in no way qualifies the holding of *Aldinger* that the jurisdictional questions presented in a case such as this one are statutory as well as constitutional . . . ." *Id.* at 372 n. 12, 98 S.Ct. at 2402.

42. The underwriter defendants rely on *United Mine Workers v. Gibbs*, 383 U.S. 715, 86 S.Ct. 1130, 16 L.Ed.2d 218 (1966), in which the Supreme Court sanctioned the joinder of state and federal law claims when such are asserted against the same defendant. In *Aldinger* the Supreme Court made it very clear that the alignment of parties and claims before it, which are analogous to those in this case, was entirely different from that presented in *Gibbs*:

> From a purely factual point of view, it is one thing to authorize two parties, already present in federal court by virtue of a case over which the court has jurisdiction, to litigate in addition to their federal claim a state-law claim over which there is no independent basis of federal jurisdiction. But it is quite another thing to permit a plaintiff, who has asserted a claim against one defendant with respect to which there is federal jurisdiction, to implead an entirely different defendant on the basis of a state-law claim over which there is no independent basis of federal jurisdiction, simply because his claim against the first defendant and his claim against the second defendant "derive from a common nucleus of operative fact."

427 U.S. at 14, 96 S.Ct. at 2420.

them.[43] Plaintiffs' state law claims against the City defendants are therefore dismissed.

Conclusion

The motions to dismiss by the underwriter and seller defendants are denied, and the motion to dismiss by the City of New York and its former Mayor and Comptroller is granted.

So ordered.

43. The underwriter defendants argue that the court should take into account the fact that the City defendants may be brought back into the case anyway on third-party claims for indemnity or contribution. *See Owen Equipment & Erection Co. v. Kroger*, 437 U.S. 365, 376, 98 S.Ct. 2396, 2404, 57 L.Ed.2d 274 (1978). There are several obstacles to such impleader. First, indemnification is not available for underwriters in a securities fraud case. *Stratton Group, Ltd. v. Sprayregen*, 466 F.Supp. 1180, 1185 n. 4 (S.D.N.Y.1979), *citing Globus v. Law Research Services, Inc.*, 418 F.2d 1276, 1288 (2d Cir.), *cert. denied*, 397 U.S. 913, 90 S.Ct. 913, 25 L.Ed.2d 93 (1970). Second, the underwriter defendants cannot seek contribution from the City defendants on the plaintiffs' federal securities fraud claims. This is because contribution may only be required of a joint tort-feasor, and the City defendants are not subject to liability under the antifraud provisions of the federal securities laws. *Id.* at 1185 n. 6, 1186 n. 7.

Impleader of the City defendants could only be based on a cause of action for contribution as to the plaintiff's state law claims against the underwriter defendants. However, even on that theory, impleader of the City defendants might be precluded. Under *Aldinger*, "the posture in which the nonfederal claim is asserted and . . . the specific statute that confers jurisdiction over the federal claim" would have to be considered "to determine whether 'Congress in [that statute] has . . . expressly or by implication negated' the exercise of jurisdiction over the particular nonfederal claim. *Aldinger v. Howard*, *supra*, at 18 [, 96 S.Ct., at 2422]." *Owen Equipment & Erection Co. v. Kroger*, 437 U.S. at 373, 98 S.Ct. at 2402. Even if the third party claim falls within the statutory jurisdiction of this court, the question would remain whether pendent party jurisdiction over the City should be retained as a matter of discretion. *United Mine Workers v. Gibbs*, 383 U.S. 715, 726, 86 S.Ct. 1130, 1138–39, 16 L.Ed.2d 218 (1966).

EXHIBIT I

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
- 83 CIV. 1758

PAUL J. BONSEIGNEUR,

Plaintiff,

-against-

R.W. BECK AND ASSOCIATES, UNITED ENGINEERS AND CONSTRUCTORS, INC., EBASCO SERVICES, INCORPORATED, WOOD & DAWSON, a law partnership, PRUDENTIAL BACHE SECURITIES INC., MERRILL LYNCH, PIERCE, FENNER & SMITH INC., SMITH BARNEY, HARRIS UPHAM & CO. INCORPORATED, SALOMON BROTHERS INC., STANDARD & POOR'S CORPORATION, MOODY'S INVESTORS SERVICE, INC., and HOUGHTON, CLUCK, COUGHLIN & RILEY, a professional corporation,

Defendants.

- x

<u>CLASS ACTION COMPLAINT</u>

<u>PLAINTIFF DEMANDS A TRIAL BY JURY</u>

FILED
U.S. DISTRICT COURT
MAR 8 11 24 AM '83
S.D. OF N.Y.

Plaintiff, by his undersigned attorneys, for his complaint, alleges on information and belief, except as to paragraphs 1, 2 and 5, as follows:

<u>JURISDICTION AND VENUE</u>

1. Jurisdiction and venue of this Court are founded on Section 27 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") (15 U.S.C. §77aa) and the principles of pendent and ancillary jurisdiction.

2. The claims alleged in this complaint arise under Section 10(b) of the Exchange Act (15 U.S.C. §§78j(b)), Rules 10b-5 promulgated thereunder by the Securities and

Exchange Commission (17 C.F.R. §240.10b-5) and under state law.

3. Many of the acts complained of, including the preparation of false and misleading offering circulars, occured within the Southern District of the State of New York.

4. In connection with the acts and conduct alleged in this complaint, the defendants, directly and indirectly, used the means and instrumentalities of interstate commerce, including the United States mails.

THE PARTIES

5. Plaintiff Paul J. Bonseigneur ("Bonseigneur"), resides at 126 163th Avenue, Bellevue, Washington. Bonseigneur purchased Generating Facility Revenue Bonds issued by the Washington Public Power Supply System ("WPPSS") for the construction of Nuclear Power Projects Nos. 4 and 5 (the "Bonds". On February 9, 1981, Bonseigneur acquired $10,000 principal amount of the Bonds.

6. WPPSS is not a defendant in this action, WPPSS is a municipal corporation and a joint operating agency of the State of Washington, with principal offices in Richland, Washington. WPPSS' membership is made up of 19 utility districts and four municipalities, all located in the State of Washington.

7. Defendant R.W. Beck and Associates ("R.W. Beck"), is an engineering and consulting firm with offices located at 7th Avenue at Olive Way, Seattle, Washington. R.W. Beck, in connection with one or more of the Bond offering circulars, issued its opinion with respect to analyses, investigations and studies concerning resources available to participants, estimated cost of power, marketing agreements, feasibility of the participants' agreement revenue requirements, and the matters relating to the issuance of the Bonds.

8. Defendant United Engineers and Constructors, Inc. ("United"), is a Pennsylvania corporation with offices located at 30 South 17th Street, Philadelphia, Pennsylvania. It was retained by WPPSS as construction engineers to provide construction and management services for WPPSS' Nuclear Project No. 4 ("Project 4"). United, in connection with one or more of the Bond offering circulars, issued its opinion with respect to analyses, investigations and studies concerning the suitability of plans and designe, the program for construction, cost estimates, the feasibility of the project from an engineering and construction standpoint, and the probable reliability of the plant in connection with the issuance of the Bonds for Project 4.

9. Defendant Ebasco Services Incorporated ("Ebasco"), is a New York corporation with offices located at Two Rector Street, New York, New York. It was retained by WPPSS as construction engineers to provide engineering, construction management and related services for WPPSS' Nuclear Project No. 5 ("Project 5"). Ebasco, in connection with one or more of the Bond offering circulars, issued its opinions with respect to analyses, investigations and studies concerning the suitability of the site, the design of the project in relation to licensing requirements, whether the program for construction was realistic, estimated date of completion, and probability of reliable operation in connection with WPPSS' issuance of the Bonds for Project 5.

10. Defendants Prudential Bache Securities Inc., Merrill Lynch, Pierce, Fenner & Smith Inc., Smith Barney, Harris Upham & Co. Incorporated and Salomon Brothers Inc. (the "Underwriter Defendants"), are broker-dealers with offices located in the City and State of New York and were principal underwriters of the Bonds.

11. Defendant Wood & Dawson (the "Wood firm") is a general partnership consisting of LeRoy Love, Cyril V. Smith, Jr., Brendan O'Brian, Samuel I. Hellman, Edward J.

McCormick, Stephen I. Turner and Thomas L. Poscharsky, engaged in the practice of law with offices located at 48 Wall Street, New York, New York. In connection with the Bond offering circulars, the Wood firm issued legal opinions regarding, among other matters, the validity of agreements between participants, the validity of a certain "Ownership Agreement" and the validity of the Bonds.

12. Defendants Standard & Poor's Corporation and Moody's Investors Service, Inc. (the "Rating Defendants"), are corporations with offices in the City and State of New York. They rate the quality of debt obligations and the prices of such debt obligations are greatly dependent upon their ratings.

13. Defendant Houghton, Cluck, Coughlin & Riley (the "Houghton firm"), is a professional service corporation engaged in the practice of law with offices located at 1111 Third Avenue, Seattle, Washington. In connection with the Bond offering circulars, the Houghton firm issued legal opinions regarding the validity of the Bonds.

PLAINTIFF'S CLASS ACTION ALLEGATIONS

14. Plaintiff brings this action as a class action pursuant to Fed. R. Civ. P. 23(a) and 23(b)(3). The class consists of all who purchased or otherwise acquired

Bonds, issued by WPPSS pursuant to offering circulars for the financing of Projects 4 and 5, as described below (the "Class"). Excluded from the Class are the defendants, members of the immediate family of each individual defendant, any entity in which any defendant has a controlling interest, and the legal representatives, heirs, successors or assigns of any defendant.

15. Because more than $2 billion in face amount of Bonds were sold, it is apparent that the Class is so numerous that joinder of all members is impracticable.

16. Plaintiff's claims are typical of the Class. He and the Class have sustained damages because of the defendants' activities as alleged herein.

17. Plaintiff will fairly and adequately protect the interests of the Class. He has retained counsel competent and experienced in class and securities litigation.

18. Questions of law and fact common to the Class predominate over questions affecting solely individual members of the Class. Among the questions of law and fact common to the Class are:

(a) Whether the federal securities laws were violated by defendants' acts as alleged herein;

(b) Whether the defendants participated in and pursued the common course of conduct complained of;

(c) Whether the offering circulars issued with respect to the Bonds were false and misleading;

(d) Whether the market price for the Bonds was artificially inflated;

(e) Whether the defendants acted willfully, recklessly or with gross negligence in omitting to state and/or misrepresenting material facts or in aiding and abetting the making of such misstatements in connection with the Bonds;

(f) Whether the Class have sustained damages and, if so, what the proper measure of damages is; and

(g) Whether the Class has a remedy under state statutory or common law for the wrongs complained of.

19. A class action is superior to other available methods for the fair and efficient adjudication of this controversy since joinder of all members is impracticable. Furthermore, because damages suffered by the individual Class members may be relatively small, the expenses and burden of individual litigation make it impracticable for Class members to individually redress the wrongs done to them. There should be no unique or special difficulty in the management of this action as a class action.

GENERAL ALLEGATIONS

20. In 1974 eighty-eight municipal corporations and cooperatives which own and operate electrical distribution systems in Washington (the "Participants") agreed with recommendations made by the Bonneville Power Administration, namely, that the Participants would need additional power from two nuclear plants by 1990.

21. The Participants agreed to help pay for the construction of Project 4 at Hanford Reservation and Project 5 at Grays Harbor County.

22. In order to raise capital for the construction of Projects 4 and 5, WPPSS issued the Bonds with a face amount of over $2.2 billion dollars and the Public Utility Defendants participated in their issuance and permitted their issuance despite their knowledge of the omissions in the Bonds offering circulars of material facts described herein.

23. In the Bond offering circulars, WPPSS indicated that agreements had been executed with the Participants which obligated them to pay for the construction of Projects 4 and 5, whether or not electricity was ever produced.

24. In January 1982, WPPSS announced that it was cancelling plans to build Projects 4 and 5.

25. Since January 1982, the Participants commenced litigation, attacking the validity of the contract described in paragraph 23 above.

26. In tha Bond offering circulars issued for Project 4, United represented that it performed the functions of project management, construction management, contract administration, planning, scheduling, costs estimating, quality assurance, cost accounting and cost control, and opined as described in paragraph 8 hereof. In addition, United prepared, in conjunction with WPPSS, cost estimates with respect to Project 4 which were materially understated.

27. In the offering circulars with respect to the Bonds, Ebasco, with respect to Project 5, opined and represented that it performed the functions of project management, construction management, contract administration, planning, scheduling, costs estimating, quality assurance, cost accounting and cost control, and as described in paragraph 9 hereof. In addition, Ebasco prepared cost estimates for Project 5 which were materially understated.

28. R.W. Beck, issued an opinion letter with respect to the results of its analyses, investigations and studies concerning a proposal by WPPSS to issue the Bonds. The R.W. Beck letter contained estimates of the construction and fuel costs for completion of Projects 4 and 5 which were materially understated.

29. In connection with the Bond offering circulars, the Wood and Houghton firms opined on the validity of the Bonds (the "opinion letters"). In the opinion letters, the Wood and Houghton firms indicated that they "examined into the validity of 72 of the Participants' agreements" to purchase electricity from Projects 4 and 5. The opinion letters, however, did not disclose that 16 of the Participants' agreements were not examined because of possible invalidities of those 16 Participants' contracts, the effect of such possible invalidities on the rights and obligations of other participants, and the effect of such possible invalidity on the credit worthiness of the Bonds.

30. The United letter was materially false and misleading in that it knowingly and/or with reckless disregard for the truth:

(a) Failed to disclose the true cost to complete Project 4; and

(b) Failed to disclose that its analyses with respect to its estimates of costs was incomplete and not made as a result of a full scale and professional review.

31. The Ebasco letter was materially false and misleading in that it knowingly and/or with reckless disregard for the truth:

(a) Failed to disclose the true costs of completing Project 5; and

(b) Failed to disclose that its analyses with respect to its estimates of costs was incomplete and not made as a result of a full scale and professional review.

32. The R.W. Beck letter was materially false and misleading in that it knowingly and/or with reckless disregard for the truth:

(a) Failed to disclose the true costs of completing Projects 4 and 5; and

(b) Failed to disclose that its analyses with respect to its estimates of costs was incomplete and not made as a result of a full scale and professional review.

33. The Wood and Houghton firms' opinion letters omitted to state material facts and were materially false and misleading in that they failed to disclose the possible invalidity of agreements of certain of the Participants regarding the financing of Projects 4 and 5.

34. The Underwriter Defendants failed to make an adequate or professional review of the Bonds and the opinions issued in connection with them and failed to inquire into the reasons for failure of the opinion letters to explain why only 72 of the Participants' agreements had been examined. Had they done so, they would have discovered the possible invalidity of the Participants' agreements and the Bonds would never have been brought to market. In the alternative, the Underwriter Defendants knew of the foregoing and brought the Bonds to market despite the material omissions described above.

35. The Rating Defendants rated the Bonds highly, despite the fact that they knew or should have known of the omissions in the opinion letters of the law firm defendants.

36. The misrepresentations and omissions described above caused the Bonds to be issued and traded at market prices artificially inflated during the class period.

COUNT I

(Violation of Section 10(b) and Rule 10b-5)

37. Defendants knew, or had they not acted in reckless disregard of the true facts, should have known that the omissions set forth above and the affacts thereof were material.

38. In the absence of information disclosing all material facts regarding the financing and other aspects as to Projects 4 and 5, plaintiff and the Class acquired the Bonds during the class period at prices which were artificially inflated because of the aforesaid omissions or the false and misleading statements knowingly circulated by or acquiesced in by each of the defendants.

39. As a result of their acquisition of the Bonds, plaintiff and the Class have been damaged.

40. As a result of the foregoing, in connection with the purchase and sale of the Bonds, the defendants directly and indirectly, by the use of instrumentalities of interstate commerce, or of the mails:

(a) Employed manipulative devices, schemes or artifices to defraud;

(b) Made untrue statements of material facts and omitted to state material facts necessary to make the statements made, and in light of the circumstances under which they were made, not misleading; and

(c) Engaged in acts, practices and a course of business which operated or would have operated as a fraud or deceit upon plaintiff and the Class.

41. In carrying out the fraudulent and manipulative scheme herein alleged, defendants, acting both singly and in concert, directly and indireccly, and by the use of the mails and other means or instrumentalities of interstate commerce, violated and/or aided and abetted violations of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, and have violated state common law regarding the sale of securities.

42. As a result of the foregoing, plaintiff and the Class have been damaged in an amount presently unknown to plaintiff. Defendants are jointly and severally liable to plaintiff and the Class.

WHEREFORE, plaintiff demands relief and judgment against all defendants as follows:

(a) Certifying this action as a Class action pursuant to Fed. R. Civ. P. 23;

(b) Awarding monetary damages against all defendants, jointly and severally, for all of the losses sustained by the Class resulting from the acts and transactions complained of herein, together with pre-judgment interest; and

(c) Awarding the Class the costs and expenses of this action, including reasonable attorney's, accountant's, and expert's fees, costs, and expenses.

Dated: New York, New York
March 7, 1983

KASS, GOODKIND, WECHSLER & LABATON

By [signature]
Stuart D. Wechsler
122 East 42nd Street
New York, New York 10168
(212) 490-2332

-and-

WOLFSTONE, PANCHOT, BLOCH & KELLEY
1117 Norton Building
801 Second Avenue
Seattle, Washington 98104
(206) 682-3840

EXHIBIT J

CRAVATH, SWAINE & MOORE

ONE CHASE MANHATTAN PLAZA

NEW YORK, N. Y. 10005

212 HANOVER 2-3000

TELEX
RCA 233663
WUD 125547
WUI 620976

CABLE ADDRESSES
CRAVATH, N. Y.
CRAVATH, PARIS
CRAVATH, LONDON E. C. 2

1933 Act/3(a)(2)
1934 Act/3(a)(12)
1934 Act/12

February 23, 1981

Dear Sirs:

On behalf of Alaska Housing Finance Corporation ("AHFC") and Dean Witter Reynolds Inc., the senior managing underwriter of AHFC's securities, we seek the Staff's confirmation of our opinions in connection with a proposed public offering by AHFC of $200,000,000 State Assisted Mortgage Bonds, Series A (the "Bonds"). AHFC is a public corporation and government instrumentality of the State of Alaska created by and pursuant to Chapter 56 of Title 18, Alaska Statutes, as amended, for the purpose of financing residential mortgage loans for persons of lower and moderate income and to promote the economic growth of remote, underdeveloped and blighted areas of the State. By statute, the Board of Directors of AHFC consists of the Commissioner of Revenue of the State, the Commissioner of Commerce and Economic Development of the State, another member who is the head of a principal department of the executive branch of State government appointed by the Governor of the State (presently the Commissioner of Community and Regional Affairs of the State) and two public members appointed by the Governor of the State. Since 1972, AHFC has discharged its public purpose through the issuance of bond anticipation notes and housing revenue bonds the interest on which has been

exempt from Federal income tax under Section 103 of the Internal Revenue Code. However, by reason of the recently enacted Mortgage Subsidy Bond Tax Act of 1980 (P.L. 96-949), interest on the Bonds will not be exempt from Federal income tax. In nearly all other respects, the Bonds will be similar to the housing revenue bonds which have periodically been issued by AHFC since 1972. The Bonds will be issued pursuant to a State Assisted Mortgage Bond Resolution (the "Resolution") which will pledge as security for the Bonds the revenues to be generated by mortgage loans purchased from Bond proceeds, together with certain other revenues and assets of the Corporation. It is anticipated that the Legislature of the State of Alaska will appropriate moneys to AHFC for the purchase of additional mortgage loans which will be similarly pledged by the Resolution, thus permitting AHFC to finance mortgage loans bearing below-market interest rates with the differential from AHFC's borrowing costs being subsidized by legislative appropriation.

Since AHFC is a "political subdivision" or a "public instrumentality" of the State of Alaska, it is our opinion that the Bonds will be exempt from the registration requirements of the Securities Act of 1933 (the "1933 Act") pursuant to Section 3(a)(2) thereof which expressly exempts securities of such issuers. This position was confirmed by the Staff within the context of AHFC's tax-exempt obligations, in a no-action letter in 1972. Alaska Housing Finance Corporation (available October 17, 1972). As explained in that request for a no-action letter, and implicitly endorsed by the Staff's response, neither Rule 131 promulgated under the 1933 Act nor the 1970 Amendments to the 1933 Act relating to industrial development bonds should affect the exempt status of AHFC's obligations since an investor is not being offered an interest in an obligation of a private company or in an industrial or commercial enterprise. The legislative history of 1970 Amendments to the Securities Acts makes it quite clear that obligations issued by state housing or mortgage finance agencies to provide mortgage loans for residential housing were intended to be exempt from the registration requirements of the 1933 Act. See statements of Senators Long and Sparkman appearing at Cong. Rec., August 4, 1970, pp. S. 12756-S. 12758 and Representative Mills appearing at Cong. Rec., July 23, 1970, p. H. 7078. See also Missouri Housing Development Commission (available January 2, 1979) and the no-action letters referred to in counsel's application for that no-action letter. There is no indication in

the legislative history of the 1970 Amendments that a different result was intended if interest on the obligations in question was subject to Federal income tax. We are further of the view that the 1933 Act status of AHFC's obligations under the 1933 Act has not been affected by the Mortgage Subsidy Bond Tax Act of 1980. That legislation (and its history) is devoid of any suggestion that the sale of a mortgage subsidy bond (as defined therein) is subject to registration under the 1933 Act notwithstanding the taxability of interest on such bonds.

We are also of opinion that the Resolution of AHFC under which the Bonds will be issued would not be subject to the Trust Indenture Act of 1939, as Section 304(a)(4) of that Act expressly exempts any security exempted from the 1933 Act by virtue of Section 3(a)(2) of the 1933 Act.

It is the intention of AHFC to apply to the New York Stock Exchange, Inc. ("NYSE") for listing for trading of some or all of the Bonds on that exchange. Section 12 (a) of the Securities Exchange Act of 1934 (the "1934 Act") provides that it shall be unlawful for any member, broker or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective under the 1934 Act.* Section 3(a)(12) defines an "exempted security" to include municipal securities as defined in Section 3(a)(29) which, in turn, utilizes language substantially similar to that used in Section 3(a)(2) of the 1933 Act. It is our view that the Bonds will constitute "municipal securities" on the basis of that definition and, accordingly, that the Bonds will not be subject to any registration and reporting requirements of the 1934 Act notwithstanding the fact that they may be traded on a national securities exchange.

We respectfully request your advice as to

---

* While the NYSE ordinarily requires that any listed security also be the subject of a registration statement under the 1934 Act, we understand that requirement has in the past been waived in the case of certain exempted securities such as U.S. Treasury Bonds and obligations of certain other governmental issuers.

whether you concur with the foregoing conclusions. Should you wish to discuss the foregoing or should you desire any additional information, please do not hesitate to call (collect) either David G. Ormsby or Henry Gross at 212--422-3000.

Very truly yours,

Cravath, Swaine & Moore

Securities and Exchange Commission,
500 North Capitol Street, N. W.,
Washington, D. C. 20549

Attention of Office of Chief Counsel,
Division of Corporation Finance.

P

O

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF CORPORATION FINANCE

Re: Alaska Housing Finance Corporation ("AHFC")
Incoming letter dated February 23, 1981

Based upon the facts presented, this Division will not recommend any enforcement action to the Commission if AHFC, in reliance upon your opinion as counsel that registration and qualification is not required, offers and sells the Bonds as described without compliance with the registration provisions of either the 1933 Act or the 1934 Act or qualification of an indenture under the 1939 Act.

Because these positions are based upon the representations made to the Division in your letter, it should be noted that any different facts or conditions might require a different conclusion. Further, this response only expresses the Division's position on enforcement action and does not purport to express any legal conclusion on the questions presented.

Sincerely,

Michael R. Kargula

Michael R. Kargula
Attorney Adviser

NOTES

2

CONSTITUTIONAL AND STATUTORY ASPECTS OF MUNICIPAL DEBT FINANCE--RECENT DEVELOPMENTS

Clayton P. Gillette

July 15, 1985

I. Developments in Federal Regulation and Taxation of Municipal Bonds -- Garcia v. San Antonio Metropolitan Transit Authority, 105 S.Ct. 1005 (1985)

A. Since Supreme Court's 1976 decision in National League of Cities v. Usery, 426 U.S. 833 (1976), there has been speculation concerning the extent to which Congress could regulate the market for and tax interest paid on municipal bonds.

1. In Usery the Court struck down as unconstitutional infringement of rights reserved to states under Tenth Amendment an act of Congress extending Fair Labor Standards Act to state and municipal employees. Court held that federal government could not mandate the way states structure "integral" or "inherent" operations in areas of "traditional local government functions."

B. Subsequent decisions attempted to refine vague standards of Usery in a manner that appeared to retreat from broad immunity from federal legislation.

1. City of Lafayette v. Louisiana Power & Light Co., 435 U.S. 389 (1978), held that municipalities are not exempt from liability under federal antitrust law when not acting pursuant to state action. No citation to Usery.

2. Hodel v. Virginia Surface Mining and Reclamation Association, 452 U.S. 264 (1981), limited Usery to cases where federal action is directed at states, addresses an "attribute of state sovereignty," and impairs state's ability to structure its "traditional functions." Upholds federal law and regulations on strip mining directed at private parties that restricts state re: land use regulation. Suggests taxation of interest on municipal bonds would not violate Tenth Amendment because directed at private parties, not at states.

3. United Transportation Union v. Long Island R.R., 455 U.S. 678 (1982), attempts to refine concept of traditional government functions but rejects historical test. Is borrowing by municipality always a "traditional

function?" Can it be when proceeds are used for "traditional" purposes?

4. <u>Federal Energy Regulatory Comm. v. Mississippi</u>, 456 U.S. 742 (1982), upheld federal law requiring state public utility regulatory commissions to consider, but not adopt, certain rate and regulatory schemes designed to save energy.

5. <u>EEOC v. Wyoming</u>, 103 S.Ct. 1054 (1983), upholds application of federal Age Discrimination in Employment Act to state and local governments. Majority opinion suggests key to immunity issue is whether federal intrusion threatens separate and independent existence of state.

C. <u>Garcia</u> expressly overrules <u>Usery</u> and declares that tests articulated in prior cases to determine scope of state and local immunity have proven unworkable. Governmental/proprietary, "historical," and "necessary" tests all considered to have logical shortcomings.

1. Majority suggests that these tests should fail because they invite judiciary to

substitute its own views for those of states and thus frustrate independence of states. Odd reasoning in light of context -- here Court permits Congress increased latitude to interfere with delivery of services by states and localities.

2. Safeguards for states lie in the political process -- Congress composed of representatives of states, not of federal government. Success of political process in protecting autonomy of states is evident, to the majority, in plethora of federal legislation that directs federal reveues into state treasuries.

3. Any role left for the judiciary? Majority suggests that some constitutionally imposed constraints remained on Congress that could be enforced by judiciary. But majority refuses to identify what these might look like.

D. Municipal bond implications of Garcia. Since Congressional acts are deemed to reflect a political process in which state representatives impose burdens on the states themselves, any withdrawal of federal tax

exemption, or increase in federal regulation of bond market would appear to pass constitutional scrutiny. Recent limits placed by Congress on used of bond proceeds would seem to survive Tenth Amendment claims.

E. South Carolina v. Regan, 104 S.Ct. 1107 (1984) as sequel. After passage of Tax Equity and Fiscal Responsibility Act of 1982, requiring that tax-exempt municipal bonds be issued in registered form, South Carolina brought action to declare provision unconstitutional as applied to general obligation bonds. State argues that provision violates states' "essential power" of borrowing by dictating a specific form of issuance for its general obligation bonds; taxation of municipal bonds constitutes a tax on the issuers themselves, thereby violating intergovernmental tax immunity established in Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895). Government contends only that suit is barred by Anti-Injunction Act. Court says Anti-Injunction Act does not bar the suit because there is no effective alternative for

challenging the validity of the tax and permits filing of complaint in its original jurisdiction. Court appoints Special Master to develop facts, as if demonstration by the state of certain level of financial injury will give rise to constitutional claim. Unclear whether this analysis survives Garcia.

F. Supreme Court solicitude for municipal action also tested in Town of Hallie v. City of Eau Claire, 105 S.Ct. 1713 (1985). At issue there was extent to which municipalities could share immunity of states from federal antitrust laws under Parker v. Brown, 317 U.S. 341 (1943). Prior decisions had suggested that antitrust immunity of states could be shared by municipalities only where there was a clearly articulated state policy for municipal anticompetitive regulation. Prior opinions also suggested that state would also have to supervise activity for the exemption to apply. These standards suggested a narrow interpretation of municipal powers and adhered to doctrine that municipalities lack sovereignty of the state. Town of Hallie

grants slightly more solicitude to municipalities. Holds that state articulation of anticompetitive policy does not have to be express. Here, general statutes authorizing municipalities to choose which unincorporated areas receive city services are sufficient insofar as they "clearly contemplate" anticompetitive conduct. Court rejects need for "active state supervision" where anticompetitive actor is a municipality once it is clear that action is pursuant to state authorization. No threat of pursuit of private interest. Little threat of pursuit of purely parochial interest.

1. Somewhat confusing distinction between private parties and municipalities. Each can be expected to act out of self-interest. Where municipal action affects only municipal constituents, political process should ensure proper action, if Court was right in Garcia. That is arguably the case in Community Communications Co. v. City of Boulder, 455 U.S. 40 (1982). May want state supervision where

municipal action affects nonresidents as was the case here.

II. Developments in the Interpretation of "Public Purpose".

A. History -- Railroad aid bonds — typically general obligation bonds backed by faith and credit (taxing power) of issuer. Subsequent to railroad collapses, public purpose requirements were included in state constitutions explicitly, or inferred from other constitutional clauses, or inferred judicially from "organic" law.

B. Criteria of "Public Purpose" -- Verbal formulas are necessarily ambiguous and difficult to apply in borderline cases. Judicial articulation of standards doesn't help much: "the promotion of the public health, safety, moral, security, prosperity, contentment and the general welfare of all the inhabitants;" "a purpose or use necessary for the common good and welfare of the people;" "confers direct benefit of reasonably general

character as distinguished from a remote and theoretical benefit."

C. Standards applied by courts:

1. Historical expansion of scope of public purpose.

2. Relationship between proposed activity and "traditional" governmental functions.

3. Effect of legislative finding of public purpose on the scope of judicial review. See discussion of Midkiff, infra.

4. (Implicitly) Availability of private capital for proposed activity (public goods theory and market failure).

5. Relationship between "public purpose" and "public use" - standard for invocation of eminent domain power.

a. Some courts use phrases interchangeably, e.g., Supreme Court of United States in Hawaii Housing Authority v. Midkiff, 104 S.Ct. 2321 (1984), upholding against a federal constitutional challenge state legislation that permitted Hawaii to take private property and transfer it to other

private parties. Court uses phrases "public purpose" and "public use" interchangeably throughout opinion as if same standard governs both.

b. Other courts construe public use more narrowly, stating that just because a project would satisfy a public purpose does not necessarily mean that it can be implemented through use of eminent domain power. City of Owensboro v. McCormick, 581 S.W.2d 3 (Ky. 1979) (invalidating act permitting taking of private property for industrial development; court says program that satisfies "public purpose" cannot necessarily be implemented by "public use" eminent domain power); Poletown Neighborhood Council v. City of Detroit , 410 Mich. 616, 304 N.W.2d 455 (1981) (condemnation of land for conveyance to private corporation upheld as public purpose; dissent argues that public purpose is more restrictive than public use).

III. Federal role in definition of "public purpose."

A. _Midkiff_ suggests federal law plays little role in defining the scope of "public purpose." On challenge to whether public use requirement of Fifth Amendment invalidates land redistribution plan, Supreme Court applies principle of _Berman v. Parker_, 348 U.S. 26 (1954). Under that case, "when the legislature has spoken, the public interest has been declared in terms well-nigh conclusive." Courts are not to interfere with legislative determinations of public use "unless the use be palpably without reasonable foundation." Here nothing palpitated. Reduction of oligopoly power constitutes classic use of state power.

IV. "Public purpose" and the use of general obligation bonds. Definition of "public purpose" has taken on new urgency as municipalities have begun to place their credit behind enterprises heretofore financed primarily through industrial revenue bonds or through private financing. In effect, municipalities have increasingly engaged in same type of financing that generated

development of public purpose restrictions a century ago.

A. Common Cause v. State of Maine, 455 A.2d 1 (Me. 1983). State entered into agreement with private concern, BIW, and with city of Portland whereby state would obtain title to floating dry dock to be developed and used by BIW at state pier in Portland. State was to transfer title to pier to city for $4.6 million. State was to assist in rehabilitation of dock for approximately $15 million. BIW received exclusive right to use dry dock for 40 year without rent or obligation to repay state for renovation expenses. City and state were to finance their financial obligations through issuance of general obligation bonds. Proposal for bonds approved by voters in referendum. Thus, major differences from industrial revenue bonds.

1. Plaintiffs argued for construction of public purpose that would limit its scope to projects that directly benefit the public or that produce goods or services available to entire public. Court rejects formalistic

interpretation or rigid guidelines for public purpose. Defers to legislative findings and looks to "potential for extensive, long-term, favorable economic impact." Finds that project will improve commerce and create jobs, generating sufficient tax revenues to repay state's investment.

2. Court rejects challenge to plan under lending of credit clause of state constitution. Court finds that prohibition was intended dto "proscribe suretyship or loan guarantee arrangements, not to affect the ability of the state itself to contract debt." Since state here was issuing general obligation bonds, thus incurring debt on its own behalf, constitutional prohibition is not triggered, even though bond proceeds are used on behalf of a private enterprise. Curious opinion in that it suggests constitutional prohibition applies more stringently to contingent liability of state than to direct liability of state. Opinions in other jurisdictions have upheld industrial development bond acts against loan of credit challenges on basis that state had no

liability at all since bonds issued under such acts were payable solely from revenues of subsidized project.

B. City of Charlottesville v. DeHaan, 323 S.E.2d 131 (Va. 1984). City seeks to issue general obligation bonds to assist private developer of privately owned convention center-hotel complex. Court determines that public purpose is sufficient because private benefit is not the "animating" or primary purpose of the project. Court notes that project has been approved by legislative bodies of city, county and state and rejects invitation to intervene. Rejects loan of credit challenge on theory that public purpose finding is necessarily determinative on loan of credit issue as well.

C. State ex rel. McLeod v. Riley, 278 S.E.2d 612 (S.C. 1981). State legislation authorizes issuance of general obligation bonds, proceeds of which are to promote alcohol fuel development. Legislature makes explicit finding of public purpose. Court appears to say that no sufficient public purpose exists

because the proposed benefit to the public is too "indirect and speculative." Court also finds that program violates constitutional ban on lending of credit. See industrial development bond discussion, _infra_.

D. _Byrd v. County of Florence_, 315 S.E.2d 804 (S.C. 1984). Ordinance authorizing issuance of general obligation bonds for acquisition and development of industrial park ruled unconstitutional for failure to serve public purpose. Court had previously approved industrial revenue bonds as serving public purpose; says different standard must apply where general obligation bonds are involved. Here, public benefit is too speculative in that project was not completed and occupants of park had not been identified; too much risk on public. Candid, if dubious, alteration of public purpose standard to reflect exposure of public fisc.

E. _State ex rel. Ryan v. City Council of Gahanna_, 9 Ohio St. 3d 126, 459 N.E.2d 208 (1984). Suit to enjoin issuance of general obligation bonds intended to implement urban

development plan. City passes ordinance pledging its faith and credit to payment of bonds and levies (but does not collect) additional tax to pay bonds. Court enjoins issuance. City passes new ordinance incorporating same provisions and issues bonds.

1. Court says bonds are invalid under constitutional prohibition against union of public and private credit; permits issuance of bonds intended to improve economy only if taxes are not obligated for payment. Since purpose of bond issue was to permit development of industrial park, prohibition is violated.

2. Court states that it is only the explicit pledge of tax revenue that invalidates the bonds: "If only the full faith and credit of the City . . . had been pledged" and no pledge of earmarked tax revenues had been made, no constitutional violation would have occurred.

V. Reexamination of "Public Purpose" for Revenue Bonds

A. Typically, courts apply public purpose requirement to any borrowing, whether security for bonds is general revenues or specific revenue stream of project financed with bond proceeds. But see _Faulconer v. City of Danville_, 313 Ky. 468, 232 S.W.2d 80 (1950). Recent cases suggest increasing restrictions in this area.

B. _State ex rel. McLeod v. Riley_, 278 S.E.2d 612 (S.C. 1981). In addition to general obligation bonds discussed above, state authorized issuance of industrial revenue bonds for computer and office facilities. Court says that to satisfy public purpose undertaking must provide more than remote or indirect public benefit. Funds proposed here would solve no problems confronted by sub stantial numbers of the public. Legislative findings that commercial development will serve public purpose deemed to "have no magical quality."

C. _Purvis v. City of Little Rock_, 282 Ark. 102, 667 S.W.2d 936, rehearing denied 282 Ark. 101, 669 S.W.2d 900 (1984). Tourism bonds, proceeds of which were to finance construction

of motel, deemed by majority of court to fail public purpose test. Plurality also appears to determine that issuance of revenue bonds must be preceded by debt election. On rehearing petition, court "clarifies" prior opinion to state that where city owns revenue producing facility of a genuinely public nature no bond election is required prior to issuance of bonds used to improve facility.

D. Brown v. Longiotti, 420 So. 2d 71 (Ala. 1982). City seeks to issue revenue bonds to finance construction of retail establishment. Court finds retail enterprises not included in amendment to state constitution authorizing issuance of revenue bonds. Concludes that such bonds would not serve a "significant" public purpose.

E. Reasons for narrow constructions of "public purpose" by contemporary judiciary.

VI. Recent Developments in WPPSS Litigation.

A. Denial of certiorari in Chemical Bank v. PUD No. 1 of Benton County (appeal from Chemical Bank v. WPPSS, 99 Wash.2d 772, 666

P.2d 329 (1983), 102 Wash.2d 874, 691 P.2d 524 (1984). Chemical Bank, WPPSS, and amici argue that invalidation of take or pay obligation by Supreme Court of Washington without providing any remedy for bondholders constitutes a taking by making sudden change in state law and by failing to recognize that municipalities induced extension of credit by bondholders. Petitioners also claim violation of due process for failure of Washington Supreme Court to order hearing on issue of control of projects and for failure to provide pre-issuance declaration re: validity of Agreements deemed impermissible by the Court. Takings claim, if accepted, would open broad base of liability for issuers of bonds subsequently ruled invalid.

B. Respondents argue that Takings Clause does not apply to judicial interpretations of law, but only to exercise of eminent domain power; Takings claim implicates an admitted property right while issue here was determination of existence of such a right. Respondents also argue that Washington

decisions were consistent with longstanding narrow construction of municipal powers and home rule power, as evidenced by specific "take or pay" legislation in other jurisdictions. Only change in law benefitted bondholders in that it permitted participants to bear risk of failure if they "controlled" the projects, even without ownership interest; nevertheless, Washington Supreme Court ruled that such control was lacking here. Respondents further claimed that any inducement came from WPPSS or bond counsel opinion, not from participants. No due process claim because lack of control was clear from face of documents, so no evidentiary hearing was necessary; pre-issuance validation was available in form of test case or mandamus proceeding.

C. City of Springfield v. WPPSS, 752 F.2d 1423 (9th Cir. 1985). Participant in WPPSS projects not involved in default sees declaration that it had authority to enter "net billing" arrangement with WPPSS and Bonneville Power Administration. Court finds that BPA or United States took dry-hole risk and that

participants will either receive electrical power or refund (credit) from BPA in respect of payments to WPPSS. Terms and obligations under agreements are uniformly interpreted. Authority of those terms and obligations is a matter of state law. Since, however, these are, from participants' perspective, essentially contracts for purchase of electricity, nothing in state court opinions invalidating "take or pay" arrangements suggests "net billing" is impermissible.

E. State court opinions re: liability of state for acts of WPPSS; federal securities litigation.

NOTES

3

FEDERAL TAX LAW

Henry S. Klaiman

July 15, 1985

This past year has seen a number of changes and proposals evolve in the tax law applicable to tax exempt bonds. Some of these ideas as implemented in transactions have been more gutsy than sophisticated; however, none has been or could possibly be more tumultuous than the President's Tax Proposals for Fairness, Growth and Simplicity ("Treasury II") which would drastically curtail the availability and benefits of tax exempt borrowing. Whether, when and how much of Treasury II will eventually become law are questions to which there are obviously no answers at this time. The House of Representatives Ways and Means Committee as well as the Senate Finance Committee are currently holding hearings on these questions. Although and perhaps because it is impossible to predict what the laws will be in 1986 and beyond, it is already abundantly clear that the number of transactions to be consummated in the last six months of 1985 will far exceed the extraordinary number of transactions closed in the last six months of 1984. Few, if any, issuers and bankers will take the proposed transition date of January 1, 1986 lightly thereby causing intense desire and pressure to close threatened transactions in 1985 rather than risk the wrath of Treasury II after December 31, 1985.

Although Treasury II has been the most recent major event in the tax law, other events and types of transactions this past year have made the year interesting. These can

be divided into four categories; legislation, regulations, court decisions, and transactional events.

A. Legislation

The Tax Reform Act 1984 was part of this PLI program last year so a complete discussion of this can be found in last year's materials. As with most tax legislation, and particularly recent tax legislation which often is hurriedly written and enacted, technical flaws are noted and need correction. To this end, the Technical Corrections Bill of 1985, H.R. 1800 and S.814, is slowly progressing through the tax writing committees of Congress with a mark-up session scheduled for late August, although rumors are that there will be slippage in this date. (It even may be combined with the Administration's Tax Proposal.)

The Technical Corrections Bill (the "Bill") would clarify ministerial reporting requirements regarding housing policy statements required to be published by issuers of single family bonds. (Section 161.) The Bill would also expand on and correct clerical errors relating to the qualified mortgage credit certificate program. (Section 162.) Various rifle shot exceptions to the Tax Reform Act 1984 are fixed. (Section 163.)

One of the more general cures proposed by the Bill deals with the application of the state volume cap and the manner in which a state may utilize a portion of its volume cap to finance facilities located outside its boundaries.

Facilities located outside a state and to which a state may allocate a portion of its volume limitation include (1) otherwise eligible sewage and solid waste disposal facilities or facilities for the local furnishing of electric energy or gas (Section 103(b)(4)(E)); (2) otherwise eligible facilities for furnishing of water (Section 103(b)(4)(G)); and (3) qualified hydroelectric generating facilities (Section 103(b)(4)(H)). In the case of sewage and solid waste disposal facilities, the determination of a state's use of a facility is based on the percentage of the facility's total treatment provided to the state (and its residents). In the case of facilities for the local furnishing of electric energy and gas, facilities for the furnishing of water, and qualified hydroelectric generating facilities, the determination of use is based upon the share of the output of the facility received by the state (and its residents). These clarifications are effective for bonds issued after the date of the bill's enactment. Section 164(a).)

The airport lobby has effectively pointed out the problem of volume cap facing it under the Act. Whereas publicly owned airports, docks, wharves, mass commuting facilities, convention and trade show facilities are exempt from the state volume cap, the Act requires that <u>all the property</u> forming part of the facility be publicly owned.

Since airports often have privately owned property as part of the facility complex, the Act would preclude any financing for part of the facility unless the financing obtained a volume cap allocation. The Bill would correct this by excluding from the volume cap requirements obligations for these facilities if just the property to be financed by the obligations is publicly owned. (Section 166(c).)

A real "sleeper" in the Act is the Consumer Loan Bonds provision contained in Section 103(o). In order to give this provision higher visability, the title is changed in the Bill to "Private Loan Bonds." (Section 166(a).) See <u>infra</u> for discussion of this provision.

Perhaps the biggest uproar with regard to the "technical amendments" proposed by the Bill concerns the transition rule provisions of the Act. The drafting of original Section 631(c) of the Act describing transition rules for ongoing projects left many confused and with valid arguments supporting different interpretations of these provisions. The Bill would clearly define these transition rules.

The grandfather or transition rule of Section 631(c)(3) was interpreted by many as providing protection from all the new rules imposed by the Act, other than the volume cap requirements, for all obligations with respect to facilities which either were (a) new property the construction, reconstruction, or rehabilitation of which began before

October 19, 1983, or (b) were facilities with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983. Those reaching this conclusion concluded that Section 631(c)(3) entitled "Exceptions" was an exception to the general rule of 631(c)(1) which states "Except as otherwise provided in this subtitle, the amendments made by this subtitle apply to obligations issued after December 31, 1983" and not just to the provisions of the Act which did not have their own internal effective dates. Those with their own internal effective dates are Section 624 (the arbitrage rebate rule), Section 625 (the consumer loan bond provision), Section 626 (the student loan bond provision) and Section 628(a) (the extension of the Code to Puerto Rico and possession obligations)).

Section 169(a) of the Bill would clarify, or, if the reader disagrees with this as a technical correction, would modify the transition rule of Section 631(c)(1) and (3) in two significant respects:

(1) <u>Limitation of Section 631(c)(1) to Specific Sections</u>. Section 169(a)(1) would delete "made by this subtitle" in Section 631(c)(1) of the Act and would insert, in lieu thereof, "made by Sections 622, 623, 627, and 628(c), (d), and (e) (and the provisions of Sections 625(c), 628(f), and 629(b))." Section 169(a)(2)(A) would delete "amendments made by this subtitle (other than section 621)" in section

631(c)(3)(a) and insert, in lieu thereof, "amendments (and provisions) referred to in paragraph (1)." The effect of these proposed changes would be to limit application of the transition rule of Section 631(c)(3) to the sections of the Act specified in the proposed amendment which did not have there own internal effective date. Those with their own internal effective date would not be altered or smoothed by a transition rule. This change would be effective as of July 18, 1984, the date of enactment of the Act.

As a practical matter, the limitation of Section 631(c)(3) to specified sections primarily affects consumer loan bonds, i.e., bonds which are not IDBs because they fail the 25% test is some regard but which do make, directly or indirectly, loans to nonexempt persons to the extent of 5% of the proceeds. A further definition or description of consumer loan bonds has not been forthcoming. Some counsel are applying the standards of Rev. Proc. 75-21, 75-1 C.B. 715 (i.e., at least 20% residual life and value) to "take-or-pay contracts" to conclude that a loan has not been made to the nonexempt person. In fact, after the Bill was introduced one municipal-owned utility revised its take-or-pay contract with a nonexempt purchaser of power to satisfy Rev. Proc. 75-21.

In addition to the above described utility example, there are many other obligations outstanding that helped finance projects by nonexempt users in a way that, for tax purposes, would deem the user to be the owner of the project (and hence a borrower of bond proceeds). For example, medical office buildings and airport facilities financed with more that 5% but less than 25% of the proceeds of an issue and long term leased to occupants (or actually owned by the nonexempt developer or occupant) might cause an issue to qualify as a consumer loan bond and hence be taxable. Even if these obligations were issued before the effective date of the Act (July 18, 1984), the obligations, even if commercial paper or short term bond anticipation notes, could not be refunded now if the new issue would constitute a consumer loan bond.

(2) Limitation of Section 631(c)(3) to Projects Under Construction of Under Binding Contract on October 19, 1983. Section 169(a)(2) would add additional language to Sections 631(c)(3)(A)(i) and (ii) to require, in effect, that construction of a project be underway on October 19, 1983 or that some expenditures pursuant to a binding contract entered into before October 19, 1983 be made after such date. By its terms, this change would be effective with respect to obligations issued after March 28, 1985.

The Bill's second correction to the grandfather provisions concerns projects that were under construction or under a binding contract on October 19, 1983. The question the Bill deals with is whether a refunding of an obligation issued for a project which was "old and cold" should be permitted. Some of these refunding obligations were issued subsequent to the Act. The Bill's effective date for this clarification is March 28, 1985 but the Joint Committee on Taxation Staff Pamphlet discussing the amendment states "no inference is intended that the same rules do not apply to obligations issued on or before March 28, 1985."

Consider, for example, short-term industrial development bonds issued to provide interim financing for the acquisition of an existing facility where the acquisition occurred before October 19, 1983, with no expenditures to be made subsequent to that date. Refinancing of such interim obligations would, under the terms of the Bill, be precluded. Such a change in the context of a technical corrections act seems inappropriate although at least one interpretation of the Act would support this being a technical amendment.

In certain other contexts, the proposed change could prevent reduction in the amount of tax-exempt interest payable in the future. Consider, for example, an outstanding issue of high coupon, long-term industrial development bonds issued in 1981, more than 25% of the proceeds of which were applied to the acquisition of land. Under existing law,

such bonds could be refunded to a lower interest rate only if the outstanding bonds are paid within six months of issuance of the refunding bond. The Bill would preclude even a current refunding of such bonds, assuming construction of the 1981 project was completed prior to October 19, 1983. It is difficult to perceive any sound policy objective being serviced by the prohibition of a current refunding of outstanding high coupon bonds to a lower interest rate merely because more than 25% of the proceeds of the outstanding bonds were applied to the purchase of land.

B. Regulations

The two major sets of regulations which were issued as Proposed and Temporary Regulations concern the Act and more specifically the volume cap allocations and carryover rules, Regulation Section 1.103(n), and the arbitrage rebate rules Regulation Section 1.103-15AT.

1. Volume Cap Regulations. The volume cap regulations were issued in Question and Answer format. On December 25, 1985, several of the questions dealing with carryover elections were amended to provide greater leeway for 1984 by granting carryover election approval to February 26, 1985.

2. Arbitrage Rebate Regulations. Temporary regulations relating to the special arbitrage restrictions imposed by the Act on industrial development bonds ("IDBs") were published in the Federal Register on January 7, 1985. These

regulations and new Code Section 103(c)(6), which the regulations interpret, apply to IDBs issued on or after January 1, 1985 (including refundings of pre-1985 issues such as commercial paper rollovers and "new issues" resulting from a "reissuance"). However, obligations issued under Section 103(b)(4)(A) or under Section 11(b) of the Housing Act of 1937 are exempt from these new rules. Violating the requirements of Section 103(c)(6) of the temporary regulations will result in the IDBs involved being treated as arbitrage bonds from their date of issuance so that the interest would be includible in a holder's taxable income on a retroactive basis (subject, in practice, to any applicable statute of limitations on collection of tax). Departing from traditional arbitrage notions, the temporary regulations expressly provide that events as they actually transpire, rather than the issuer's reasonable expectations on the date of issuance, will determine whether a bond issue satisfies the new restrictions.[1]

New arbitrage rules focus primarily on two major requirements: (1) the rebate requirement, and (2) the limit on nonpurpose investments.

---

1. An inadvertent, insubstantial error (e.g., arithmetic) that is corrected within a reasonable time will not cause the issue to become taxable.

a) The Rebate Requirement. In general, issuers of IDBs issued on or after January 1, 1985 must rebate all arbitrage profit earned to the United States, even if such profit is earned on amounts eligible for unrestricted investment during the customary three or five year "temporary period" or on amounts eligible for unrestricted investment that are on deposit in a "reasonably required reserve or replacement fund." Section 1.103-15AT(d)(1). Thus, while the new restrictions do not limit the permissible yield on acquired nonpurpose obligations during a temporary period or when held in a debt service reserve fund (except, in the latter case, where limited to 150% of debt service as discussed below), an issue must rebate the excess of amounts actually earned on nonpurpose obligations acquired with the proceeds of the bonds over the amount that would have been earned if such nonpurpose obligations had a yield equal to the yield on the bonds, plus all income earned on such excess.

For this purpose, "yield" is calculated using as purchase price the initial offering price to the public at which a substantial amount of the obligations was sold or, if a private placement, the acquisition cost of the first buyer. Since issuance costs and underwriter's discount are not permitted to be deducted from the purchase price, an issuer will be unable to recoup any portion of these costs (except where the six-month temporary period applies, as

discussed below). Similarly, in calculating yield on nonpurpose obligations, no reduction to the amounts received on such obligations is permitted for transaction costs incurred in acquiring, carrying, selling, or redeeming such obligations. The term "nonpurpose obligation" means any security or obligation in which the "gross proceeds" of an issue are invested and which is not acquired to carry out the governmental purpose of the issue. "Gross proceeds" includes original proceeds, sinking fund proceeds, pledge fund proceeds, investment proceeds (including amounts received as interest on acquired purpose obligations such as the interest component of lease payments), other amounts received with respect to acquired obligations (such as principal payments), transferred proceeds, replacement proceeds[2] and "other amounts received as a result of investing these proceeds." See Section 1.103-15AT(b)(6).

The issuer must calculate the amount of rebate owed to the United States at least annually (the year commencing on the date of issue and ending one year later, and each subsequent year, being a "bond year") as well as on retirement

---

2. The preamble to the temporary regulations indicates that it is anticipated that future regulations will define the concept of replacement proceeds for all purposes of Section 103(c), potentially expanding the categories of replacement proceeds that are considered gross proceeds.

of the last obligation of the issue. Actual rebate payment, however, need only be made very five years, with the first payment being due not later than 30 days after the end of the fifth bond year of the issue. Section 1.103-15AT(e). The final payment is due not later than 30 days after the retirement of the last obligation of the issue. The examples in the temporary regulations indicate that the rebate amount is determined on a cumulative basis, with credit being taken for prior amounts rebated. See Section 1.103-15AT(e)(4) (Examples 1 and 2).

In calculating the amount owed to the United States, all income realized with respect to the nonpurpose obligations must be taken into account. This includes, for example, gain or loss realized on the disposition of such obligations. Additionally, if a nonpurpose obligation is retained after the retirement of the last obligation of an issue, any unrealized gain or loss as of the date of the retirement must be taken into account. Gain or loss on disposition or retirement of an obligation is calculated using as the basis of such obligation its fair market value on the date it becomes a nonpurpose obligation. The effect of this rule is to restrict an issuer's or borrower's ability to allocate existing low-yielding securities to the bond issue in order to come within yield limitations and avoid the rebate requirement. This result is unlike that

under current arbitrage regulations, where allocation of low-yielding securities to a bond issue is permitted and is an effective way to utilize such investments. Furthermore, if the bond documents require continuing revaluation of accounts, such revaluations must also occur for yield calculation purposes. See Section 1.103-15AT(c)(3). Section 1.103-15AT(d)(2) and the accompanying examples provide further detail on the calculation of the rebate amount.

There are three special rules with respect to the rebate requirement. First, if an election is made, earnings on amounts deposited in a bona fide debt service fund need not be taken into account in calculating the rebate amount if the gross earnings on such fund for a bond year is less than $100,000. (Except in low-yielding floating rate transactions, one would normally wish to include these nonpurpose obligations in the yield calculation since it is likely that the negative arbitrage produced by these obligations would offset positive arbitrage on other nonpurpose obligations, thereby reducing the amount subject to the rebate requirement.) This election must be made on the date of issue in the bond indenture or a related document (for example, the aribtrage certificate) and is irrevocable.

Second, the rebate requirement does not apply to an issue if all gross proceeds of the issue, other than those

deposited in a bona fide debt service fund, are expended for the governmental purpose of such issue within six months of the date of issuance. A debt service reserve fund will generally cause this six-month exception to the rebate requirement to be unavailable.[3] Additionally, earnings on any unanticipated gross proceeds that arise subsequent to the initial six-month period following an issue, to the extent they exceed the amount that would have been earned if such gross proceeds were invested at the yield on the bonds, must be paid to the United States. Otherwise, the rebate requirement will retroactively apply to all amounts earned with respect to gross proceeds.

Section 1.103-15AT(d)(5) of the temporary reguations provides special rules for determining whether the proceeds of a refunding issue are expended for a governmental purpose. Proceeds used to refund outstanding obligations of an issuer are considered expended for the governmental purpose of the prior issue. However, proceeds transferred from the original issue ("transferred proceeds")[4] are not considered expended

---

3. The Treasury is studying the possibility of permitting the establishment of a reserve fund if it is invested in SLGs with a yield no higher than the bond yield.

4. Under existing arbitrage regulations, as the principal of the prior issue is discharged, unexpended proceeds of the issue become "transferred proceeds" of the refunding issue on a pro rata basis.

for the governmental purpose of the original issue unless such proceeds are expended within six months of the date of the original issue.

The third special rule with respect to the rebate requirement provides that bonds will be arbitrage bonds if a "prohibited payment" is made. "Prohibited payment" is defined as the payment of (or agreement to pay) to a party other than the United States an amount required to be paid to the United States. The example posed by the new regulations is one in which the issuer or borrower purchases a nonpurpose obligation at a price in excess of its fair market value either to increase its basis in the obligation and thereby reduce any gain on its disposition or to reduce the yield on the obligation to comply with arbitrage restrictions and at the same time pass the benefit through to the issuer or seller of the obligation. The temporary regulations accordingly provide that the excess of the price paid over the obligation's fair market value is considered a prohibited payment. See Section 1.103-15AT(d)(6)(i). Various certifications are required if investments are made or sold in the absence of an active secondary market. In this regard, the regulations provide special rules for certificates of deposit and investment contracts.

b) Limitations on Investment in Nonpurpose Obligations. In addition to the rebate requirement, a new limit has

been imposed on the amount of gross proceeds of an issue that may be invested in nonpurpose obligations with a yield in excess of the yield on the bonds (e.g., the investment of the debt service reserve fund in higher yielding securities is limited). Such amount may not exceed 150% of the debt service on the bonds during a particular bond year, and such amount must be reduced in later bond years as the amount of bonds outstanding (and the debt service on the issue) is reduced.[5] (Investments in lower yielding nonpurpose obligations and tax-exempt obligations are not limited.) Several temporary periods, as discussed above, are provided during which proceeds invested as described in the temporary period exceptions to existing arbitrage regulations will be disregarded for purposes of the 150% limit. See Section 1.103-15AT(c)(2). For purposes of determining the amount of gross proceeds invested in nonpurpose obligations, each such obligation is valued as if acquired for its fair market value at the time it becomes a nonpurpose obligation, similar to the rule for determining the amount of rebate.

For issues containing variable rate obligations, yield and debt service must be determined on the first day of each bond year in order to determine whether the 150% limit will

---

5. This assumes that the amount of debt service will decline as the principal of bonds is paid. However, such reduction should not be necessary where debt service remains constant although the interest and principal components shift.

be met. The interest rate on the obligations for the first bond year is assumed to be the initial rate on the date of issuance except that, for this purpose, the initial rate that is fixed in the documents as a guarantee until the floating rate mechanism operates may not be used. Apparently, the stated formula for calculating the interest rate after such initial period must be utilized. For subsequent bond years, the weighted average rate for the variable rate obligations during the preceding bond year is used to establish debt service for the subsequent year. Similar assumptions apply in determining the rate of interest on acquired nonpurpose obligations.

These new regulations provide a thirty-day grace period for each year for the purpose of permitting the issuer to comply with these new investment limitations, although the regulations currently require the calculation itself to be performed on the first day of each year. The thirty-day compliance period does not appear to be available in a fixed rate issue. Also, Section 1.103-15AT(c)(5) of the temporary regulations contains special rules that do not require the liquidation of nonpurpose obligations when a loss in excess of the rebate amount would be incurred in disposing of such nonpurpose obligations in order to satisfy the 150% investment limitation. Because of this exception to liquidation of an investment portfolio and the rules regarding the determination of what constitutes an investment for this

purpose, it appears advisable for an issuer to purchase a single block of similar securities at one time rather than to purchase different types of securities or to purchase similar securities but on different purchase dates.

3. <u>Federal Guarantee Regulations</u>. Federal Guarantee Regulations have been rumored to be ready for imminent release since January, 1985. As of this date, they have not been promulgated. The question of whether an issue is federally guaranteed and therefore taxable has been raised in a variety of financings. This prohibition, originally intended to stop FSLIC-backed housing bonds, was extended in the Act. The determination of the reach of this provision is awaiting release of regulations. In the meantime, the following types of obligations have been suspect:

(1) Those that have financed real property of which the United States Government is a tenant, even if only a minor tenant such as a military recruitment office or a post office in a shopping center or office building;

(2) Those that have financed factories or production equipment where the federal government is a purchaser of product, either that product produced in or by the facility or product produced by other facilities of the owner-lessor which generate revenues that can be used for payment of the debt;

(3) General obligations of educational institutions that receive "grant money" from the federal government, and

(4) Highway bonds which will be paid by the state from United States highway funds received by the state upon satisfactory completion of construction.

The Joint Committee Report on the Act, at Page 939, states "Congress intended the determination fo whether a Federal guarantee exists to be based on the underlying economic substance of the transaction, taking into account all the facts and circumstances in this regard. The transfer of risk to the Federal Government is a key element in determining whether such a guarantee exists."

Despite this explanation, informal indications are that a federal guarantee may be deemed to exist even when the federal government has no obligation other than an obligation (i) to pay for goods received or services rendered (especially if pursuant to a long term contract, even if not a take-or-pay contract) and (ii) to reimburse an entity for expenditures when such reimbursement is contingent on satisfactory performance.

C. Judicial Decisions

In Philadelphia Gear Corporation v. FDIC (10th Cir. Dec. 27, 1984) and William Henry Allen v. FDIC (E.D. Tenn. Oct. 24, 1984), courts held that a bank letter of credit

constitutes a deposit insured by the FDIC. The FDIC's request for a rehearing in the Philadelphia Gear case was denied by the full U.S. Court of Appeals for the Tenth Circuit. An appeal from the Allen case is presently before the Sixth Circuit. These decisions have raised the concern that backing by FDIC and possibly FSLIC constitutes a federal guarantee with the result that the interest on the bonds would not be tax exempt.

Prior to transitional relief from the Internal Revenue Service, law firms took two approaches to this problem. Some concluded that the language of Section 103(h) of the Code together with the legislative history concerning Section 103(h) establish that even if a letter of credit constitutes a deposit insured by the FDIC, the letter of credit does not constitute a federal guarantee under Section 103(h). Interestingly, after the IRS issued transitional relief, some of these firms concluded it was necessary to adopt a more conservative analysis. Other firms took the position that while a letter of credit insured by the FDIC might not constitute a federal guarantee for purposes of Section 103(h), the issue was not entirely clear. These firms required some type of waiver on the part of prospective bondholders of the right to any FDIC deposit insurance which might become available. Because of the uncertainty that a waiver by the bondholder might be unenforceable as against

public policy, some firms adopted the "exploding L.O.C." approach which required the trustee and bondholders to agree that, without an opinion of counsel, they would not enforce the L.O.C. against the issuing bank in the event the bank became insolvent. Other similar techniques, or a combination of several, were utilized.

In late March, the FDIC sent legislation to Congress addressing, among other things, the question of whether a letter of credit is backed by FDIC insurance. The bill would clarify that a letter of credit issued by any FDIC insured bank is not a deposit and, therefore, is not backed by federal deposit insurance. The bill, consequently, would have the effect of making it clear that a letter of credit would not constitute a federal guarantee under Section 103(h) of the Code.

The FDIC sponsored bill at present apparently does not contain a section which would make retrocactive the provision which excludes letters of credit from the definition of a deposit covered by FDIC insurance. If this provision is to be effective on date of enactment, then it would only protect bonds issued subsequent to that time, and the tax-exempt status of bond issues supported by letters of credit which are issued prior to that date would still be uncertain.

The Service, on April 1 and again on April 26, announced that proposed Treasury regulations will provide that state

or local government obligations issued first before May 2, 1985 and later, before January 1, 1986, and guaranteed by letters of credit issued by banks whose deposits are insured by the FDIC will not be treated as federally guaranteed obligations under Section 103(h) of the Code solely because of the letters of credit. The Service stated that the tax-exempt status of obligations issued after December 31, 1985 secured by letters of credit will not be protected by this grandfather provision but will depend on the state of the law after that date.

Recently, an associate attorney at the New York State Banking Department sent a letter, dated May 31, 1985, to counsel for a major money center bank in New York which concluded that, given the facts set forth in a request letter, the bank could characterize credit enhancement functions performed for bond issuers as transactions performed pursuant to a "guaranty." The purpose of the request was to avoid the problems raised by Philadelphia Gear for the issuance of letters of credit by FDIC-insured banks.

Banks, whether national banks or state-chartered banks, have powers limited to those specifically authorized by the National Bank Act or the respective state banking law, as the case may be. Although much has been written and the case law is extensive, there has emerged only a confused consensus that banks, generally, cannot issue guaranties, but may issue

standby letters of credit as long as the standby letter of credit meets certain criteria to distinguish it from an otherwise impermissible guaranty.

Recent amendments to Section 96.9 of the New York State Banking Law led to two opinions in 1984 by the Deputy Superintendent and General Counsel of the Banking Department on the issue of permissible guaranties. The May 31, 1985 letter relied upon those earlier opinion letters in reaching its conclusion.

Although the letter is relevant only to New York State chartered banks, characterizing a standby letter of credit as a guaranty in credit enhancement context may be a concept worth pursuing with the Comptroller of the Currency in the case of national banks or various state banking regulators, as the case may be. In any event, it may be an interesting circumvention of the issues raised by Philadelphia Gear should the FDIC bill not be enacted and IRS not extend its current non-enforcement position.

D. Transaction Considerations and Developments

The balance of this article is directed towards some of the more important transactional developments this past year.

1. Structure. Perhaps one of the major developments this year has been the rapid growth of and added refinements to floating rate obligations. These obligations, often

denominated as having a 30 year or more maturity, are marketed to short term investors by granting a short term put to the investor and including a liquidity device, such as a letter of credit or liquidity agreement, in the transaction.

The basic tax analysis attributable to floating rate obligations is well documented in an article by Phillip S. Winterer published in the Spring, 1984 issue of The Tax Lawyer, 509. In this regard little has happened in the tax law to provide additional support to either proposition that conversion from a floating rate short term put obligation to a fixed rate long term instrument constitutes, or does not constitute, a refunding or reissuance, i.e., the issuance of a new instrument for proceeds which are used to retire the old issue. Perhaps the only new authority, if a private letter ruling can be so classified, is P.L.R. 8451018 which, prior to its withdrawal for other reasons, considered a floating rate short term issue which, on the happening of certain events, converted to a long term issue as a single issue.

Despite the absence of new authority and the still apparent hesitancy of many tax lawyers to opine that a conversion under any circumstances from a floating rate to a fixed rate does not constitute a reissuance, a trend has developed to permit the put period during the floating rate

portion of the obligation to be adjusted with relative frequency and freedom. Most investment banking firms have developed their own name for such a security. The resolution of whether these frequent optional changes in the put period constitute a reissuance is still in doubt with some tax lawyers still uncomfortable with the unilateral ability of the issuer to change the interest rate on the issue via altering the put period. Few, if any, tax lawyers will opine that such a program is a reissuance; even those concerned will merely state they are not comfortable in opining that the program does not constitute a reissuance. Nevertheless, there are a few firms, and not necessarily those which have opined favorably on the question of the conversion to a fixed rate, that have opined that the unlimited (or relatively unlimited) adjustment of the put period does not constitute a reissuance. The theories of these firms vary from (a) relying on an independent remarketing agent establishing the put period i.e., not as an agent of the company or issuer and "truly independent," (b) to the conclusions that the changes are within narrow patterns which patterns are pre-programmed in the original issue, (c) to the conclusions that the interest rate variations are not significant enough to constitute a new issue.

The fact that the flexible put period obligations are issued does not necessarily indicate the opinion of bond

counsel as to the tax consequence of the change of the put period. A few counsel have issued "normal" opinions without making note of the flexible put arrangement. As in commercial paper programs, other bond opinions in these transactions may be an "evergreen" opinion so that it can be relied upon only so long as the law does not change (or become adverse!).

There is a tension in utilizing the flexible put concept because often its utilization will prevent a law firm that would otherwise opine favorably with respect to a conversion to a fixed rate from giving such an opinion. The issuer, therefore, must make a business decision as to which risk it is willing to run and what the ultimate cost of that risk might be should the law change or be clarified for the worse.

2. Sizing Concerns. Another problem that must be resolved when floating rate - fixed rate obligations are issued for new money projects is the size of the capitalized interest fund, the reserve fund, and the ability to fund the conversion costs (especially if the issue is an industrial development bond when the 90%-10% test is concerned). The obvious obstacle is the question of overissuance -- especially if the temporary periods under the arbitrage regulations are being utilized.

The first question, at which rate should the capitalized interest fund be established and the concurrent question of what earnings rate of the construction and other funds should be assumed as a set-off in sizing should be addressed together. These questions cannot be answered in a vacuum but, it is submitted, must be answered on an ad hoc basis giving due regard to the market trend, the investment portfolio, the historical market rate, and the need for adequate funds. Some counsel adhere to the non-judgmental conclusion utilizing the rate at which the issue is first sold while other counsel will weigh the facts, ask the underwriter for representations as to the reasonableness of assumptions, and second-guess the underwriter to some extent. The decision is easier, of course, if any excess capitalized interest can be spent on new or unfunded projects when such excess proceeds becomes available. Furthermore, the very uncertainty of floating rates should justify the conclusion that a reasonable judgment not too much in excess of the current rate would not constitute an intentional overissuance, thus permitting one to rely on the 5% overissuance rule to maintain temporary periods.

The size of the debt service reserve fund can be analyzed in a manner similar to the capitalized interest fund. First, what support is there that a debt service reserve fund is necessary? Has a decision been made never to convert to a fized rate issue? Is the liquidity provider requiring a

reserve as protection against a draw on it? Assuming a reserve is justified, what interest rate should be assumed if maximum principal and interest is the proper size but the interest rate would not be known until conversion occurs? Again, tax lawyers differ in this regard. Some take a non-judgmental position that the fixed rate on the day the bonds are first issued is the measuring rate (relying on Private Letter Ruling 8451018) whereas other firms will allow some *ad hoc* decisions to be made, especially if the issuer will represent the likelihood of conversion within the construction period, *i.e.*, within a short time after the issue is first sold. Upon partial or total conversion, steps are often required to resize the continuing reserve fund with the excess, if any, used for good projects, used to reduce the issue, or escrowed at a zero arbitrage yield if necessary.

Finally, because there will often, if not always, be an underwriter spread and other costs of remarketing the securities upon conversion from a floating rate to a fixed rate, issues often are sized to include an amount to fund such costs. Assuming the rebate rules would not otherwise apply because of the six month temporary period, such a fund may not be advisable in the case of an industrial development bond. If the fund is created, however, the further decision must be made whether this fund, and its expenditure, constitutes "good," "bad," or "neutral"

costs for the 90-10% "substantially all" tests of Section 103(b)(4). Although there may be a difference of opinion, this writer has only opined that the fund constitutes a "neutral" amount. However, rumors abound that others have considered such fund constitutes "good" money. Interestingly, one firm has concluded the fund constitutes "good" money but the conversion constitutes a refunding. It is possible this firm is re-examining this conflict.

3. Year-End "Escrow" Transactions. At the end of 1985, and we must expect at the end of 1986, debt was issued for possible projects which ranged from housing projects to airports, with hospitals and resource recovery plants in between. Each of these had one common thread -- the issues were sold earlier than they might normally have been in order to achieve a marketing advantage and at the same time avoid at least one adverse change in the tax law -- be it the volume cap or the arbitrage rebate rules. Some of these projects were clearly more than a gleam in the eye of the issuer with millions of dollars committed and spent on the project. Others, one might suspect, were little more than a gleam. These latter transactions, much publicized, will likely support the Administration's position that additional controls are needed. As we learned in law school, bad facts make bad law. The appropriateness of an accelerated issue is an ad hoc decision with the judgment of

the lawyers often being difficult to assess because of the lack of knowledge of all the facts. The appearance of impropriety, however, raises suspicion and can be demoralizing to both the legal and investment banking profession; especially in the absence of enforcement by the Internal Revenue Service. The only apparent reaction to the problem was the revocation of Private Letter Ruling 8451018 and the release of Revenue Procedure 85-28 advising that the IRS will no longer rule when the proceeds are placed in escrow or otherwise not expended for a governmental purpose in an extended period of time. On May 6, 1985, the IRS instituted a project to study the question of early issues. The first report is due in ninety days, but this does not mean any report will be made public.

4. Arbitrage and Yield Concerns. A frequent transaction in single family mortgage bonds has been the multi-coupon (high-low) issue in which the issuer utilizes the long term stated interest rate in calculating yield but the purchaser is provided an optional supplemental agreement, usually with a bank, wherein the purchaser, shortly after purchase, may irrevocably elect a floating rate in exchange for granting the fixed rate to the bank. The fixed coupon rate is lower than the fixed market rate at the time of issue, thus providing a benefit to the issuer. If the issuer can categorize the fixed rate as interest, it has the best of both worlds -- a lower cost and the ability to lower the cost

of the mortgages as well as recover it "outside" the 1-1/8% spread. If the difference between the floating rate and fixed rate is not interest but rather a carrying cost, the issuer could not recover this cost outside the permitted 1-1/8% spread.

The categorization of the additional payment as interest is difficult. Some lawyers believe the analysis must be made on the basis of economics -- is there an economic compulsion on the holder to elect the floating rate? If so, then the additional payment is not interest but rather represents a cost of issue. Factors which must be considered are the lapse of time before the purchaser must make a decision and the spread between the stated fixed rate and the market rate at the time of issue. Often representations are obtained as to the likelihood of the fair market value of the issue at the stated rate being greater than the fair market value of the issue at the floating rate to support the lawyer's decision. However, counsel differ as to the need to make an economic analysis -- some rely on the form of the transaction. Interestingly, it has been rumored that some banks that have participated in these transactions have incurred large losses because the decline in interest rates has resulted in purchasers retaining the fixed coupon.

Another issue that must be resolved in this structure is whether the purchaser is buying an obligation of the

issuer or, on the other hand, is lending money to the bank, which loan is secured by the issue -- i.e., is the transaction merely a "repo" so that the bank is entitled to the exemption of interest. This is a difficult question which has been resolved in most cases by terminating the agreement with the bank several years prior to the maturity of the issue so that the purchaser does have a risk as to the issue for a period of time. Furthermore, often the issue is not "putable" to the bank in the event of a default. The addition of an independent insurance policy to cover default makes the analysis of owner even more difficult because the risk of loss is substantially reduced.

5. Floating Rate Refundings. Not much new has occurred in this area. Other than a few refundings which have purchased defeased municipal obligations for the escrow, few issuers (apparently for business reasons) have resorted to the more complicated adjustable reserve or the remaining investor-take-all methods. Despite the absence of transactions, except when the two year temporary period is utilized, there is still an abundance of discussion on achieving a floating rate advance refunding -- though perhaps less than a year ago.

6. Short-to-Short Crossover Refundings. A relatively new concept is the advance refunding of a floating rate transaction with another floating rate issue which adjusts interest rates more frequently. For example, a weekly

floater is refunded with a daily floater, often using the two year temporary period through the availability of the crossover refunding technique. Assuming the escrow is invested at a two year rate and the refunding issue begins paying a two year rate prior to retiring the refunded issue, the refunding issue can be fully secured during the escrow period. If a two year rate is not desirable, a shorter rate adjustment period can be utilized immediately if satisfactory credit for any shortfall can be obtained and coverage requirements in the outstanding indentures can be satisfied. Upon the retirement of the refunded issue, the refunding issue would move from paying a two year rate to a floating rate which varies more frequently than the refunded issue. To date, most counsel that have approved this structure have required a showing of debt service savings (in excess of issuance costs) over and above any arbitrage income from the utilization of the two year temporary period.

7. Continuous or Rolling Crossover Refundings.

Although utilized for other purposes at other times, the crossover refunding technique has become attractive to issuers of floating rate issues that are concerned about a conversion to a fixed rate at an uncomfortably high interest rate. For this reason, a crossover refunding issue, which locks in today's fixed rate and, at the same time, provides the issuer with the advantages of a lower floating rate,

would be a conservative business approach to managing the liability side of the issuer's balance sheet. Moreover, a crossover refunding issue would help to eliminate the frustration certain issuers are currently having with the Administration's tax proposal that could curtail future financings.

The crossover refunding technique, which is referred to in the U.S. Treasury arbitrage regulations, provides that the interest earnings on the escrowed investments purchased with the proceeds of the refunding bonds will be used to pay the interest on the fixed rate refunding bonds. The interest on the floating rate refunded bonds is paid by the issuer. Principal amortization of the refunded bonds is paid from maturing investments in the escrow and principal of the refunding bonds is paid by the issuer. The principal amortization of the two issues are often matched to avoid disruption to the issuer's anticipated debt service schedule.

Leaving aside the temporary period that might be available were the refunded bonds retired in no more than two years from the date of the issuance of the refunding bonds, the proceeds of the refunding bonds held in escrow cannot be invested at a yield that produces an arbitrage profit i.e., at a yield in excess of the yield of the refunding bonds. Certain costs of issuing the refunding bonds can be taken into account in computing the yield on

the refunding bonds and, as long as the escrow remains invested, may be partially recovered.

The regulations do not specify when the proceeds of the refunding bonds held in the escrow account must be applied to retire the floating rate bonds. In light of this, the technique has developed wherein the floating rate bonds are not retired at the first maturity of the escrowed investments but rather are retired at some subsequent time (except for the floating rate securities maturing during this period which are retired as they mature with escrowed proceeds). The escrowed funds are reinvested. This technique has been referred to as a "rolling crossover" because the escrowed investments continue to be reinvested or rolled prior to the utilization of the funds to retire the refunded bonds. In this type of continuous reinvestment of the escrowed funds the question has arisen whether such reinvestment, as well as the failure to designate a definitive retirement date, is permitted by the arbitrage regulations, thus allowing the interest on the refunding bonds to remain tax exempt.

Those bond counsel who have approved this refunding technique have developed basic requirements that they require to be satisfied by a crossover refunding structured as a rolling crossover. The basic legal question is whether a rolling crossover issue constitutes a refunding issue or a hedge transaction, which does not clearly qualify under the arbitrage regulations. The state law, of course, must be

addressed in each case to see if state law permits this type of transaction. Some bond counsel believe that the transaction will qualify as a refunding and not a hedge transaction for federal tax purposes if the funds derived from the refunding issue are used to retire the refunded bonds and if such retirement occurs when a material amount of refunded bonds are outstanding and would remain outstanding, absent retirement, for a material period of time.

The following points are examples of the requirements frequently suggested:

1. The escrowed investments are invested in either open market securities, Treasury obligations, or a guaranteed investment contract at a yield limited to the yield on the refunding bonds. The "market price" rules imposed by the Treasury regulations must be met with regard to the purchase price for those investments. Moreover, in order to assure that the yield on the escrowed investments does not violate the arbitrage rules, the escrowed investments cannot be liquidated or sold at a gain if the gain would cause the yield on the investments to exceed the yield to date on the refunding bonds.

2. The payment of interest and principal on the floating rate refunded bonds and on the fixed rate refunding bonds would be arranged as described above.

3. It is expected that the initial term of the escrowed securities would be the shortest term which permits the

securities to be invested at a yield no greater than the yield on the refunding bonds.

4. On the date the escrowed investments mature, the securities would be used to retire the balance of the outstanding floating rate refunded bonds. On the other hand, assuming proper notice, the issuer and trustee, upon receipt of a favorable opinion of bond counsel can reinvest the escrow for an additional period of time.

5. If the investments in the escrow are reinvested at a subsequent date, any subsequent reinvestment will be subject to the same rules as above. The escrow may not, however, extend beyond the time which would result in the refunded bonds not being retired while a material period and amount of refunded bonds would otherwise remain outstanding. For example, floating rate refunded bonds with a thirty year term should be retired no later than ten years prior to the scheduled maturity of the refunded bonds, assuming that at least one-third of the refunded bonds remained outstanding at that time.

6. The issuer must agree in the documents that the floating rate refunded bonds will not be redeemed or retired except with the proceeds of the refunding bond held in the escrow.

7. In order to avoid the appearance of a pure hedge transaction and to support the conclusion that the refunding bonds satisfy the governmental purpose requirement under the

arbitrage regulations, the issuer must covenant not to refund the refunding bonds until the floating rate refunded bonds have been retired.

8. The issuance dates of the refunded bonds and refunding bonds must be separated by a substantial lapse of time. Some counsel have established fixed lengths of time. Other counsel rather than set any predetermined length of time, will consider the intent of the issuer at the time the refunded bonds were issued as well as any significant change in circumstances that might have arisen since then that indicate the refunding bonds were not anticipated or planned when the floating rate refunded bonds were issued.

9. Finally, the escrow for the refunding bonds must be terminated in the event that excess proceeds, as defined in the arbitrage regulations, exceed the sum of (i) interest to accrue on the refunding bonds to the next potential crossover date and (ii) one percent of the original proceeds of the refunding bonds.

In this type of transaction, the issuer assumes some risks. First, because of the investment of the escrow for fixed periods, the issuer will not be able to retire the floating rate refunded bonds at all times unless it is willing to take a loss on the sale of the escrow securities. For example, if the investments have increased in value, the yield limitation requirement discussed above may also

prevent the liquidation of the escrowed investments and the retirement of the refunded bonds. Second, if the law should require the escrow to be liquidated and the funds used to retire the floating rate bonds in order to assure the exemption from federal income tax of the interest on the refunding bonds, the issuer would be required to act in such a manner to enable the refunding bonds to retain their tax exempt status. This could result in the acceleration of the retirement of the refunded floating rate bonds to the detriment of the issuer. This would be even more disadvantageous if the issuer is prevented by statute from later refunding the fixed rate refunding bonds with floating rate bonds, either in an advance refunding or current refunding. These are business decisions, of course, which the issuer must resolve.

July 15, 1985

4

DISCLOSURE REQUIREMENTS AND THE ROLE OF COUNSEL IN TAX EXEMPT FINANCINGS

Stephen L. Dinces

Mr. Dinces would like to express his appreciation to Richard S. Lincer for his assistance in the preparation of this outline.

August 19, 1985

Disclosure Requirements and the Role
of Counsel in Tax Exempt Financings

I. Disclosure: Both a Legal and a Market Concept.

A. Legal Framework.

1. Federal Securities Law Requirements

(a) Section 10 of Securities Exchange Act of 1934, as amended ("Exchange Act"), and Rule 10b-5

(i) Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (scienter required for violation of 10b-5; reckless conduct generally held sufficient to satisfy scienter requirement, see IIT v. Cornfeld, 619 F.2d 909, 923 (2d Cir. 1980).)

(ii) see SEC v. Calhoun County Medical Facility, Inc., [1981-82] Fed. Sec. L. Rep. (CCH) ¶ 98,243 (D.C. N. Miss. 1981); SEC Release No. 34-17831. (Case sometimes referred to as SEC v. Sklar.)

(iii) Nelson v. Quimby Island Reclamation District Facilities Corp., 491 F. Supp. 1364 (N.D. Cal. 1980); Baron v. Commercial & Industrial Bank of Memphis, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,826 at 95,307-08 (S.D.N.Y. 1979) - both cases discussed below

(iv) will a private cause of action for liability lie against a municipal issuer as a result of the redefinition of "person" in Section 3(a)(9) of the Exchange Act by the Williams Amendments to include a "government, or political subdivision, agency or instrumentality of a government." See In re New York City Municipal Securities Litigation, 507 F. Supp 169, 180-86 (S.D.N.Y. 1980);

Disclosure Requirements and the Role of Counsel in Tax Exempt Financings

I. **Disclosure: Both a Legal and a Market Concept.**

A. **Legal Framework.**

1. **Federal Securities Law Requirements**

(a) Section 10 of Securities Exchange Act of 1934, as amended ("Exchange Act"), and Rule 10b-5

(i) Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (scienter required for violation of 10b-5; reckless conduct generally held sufficient to satisfy scienter requirement, see IIT v. Cornfeld, 619 F.2d 909, 923 (2d Cir. 1980))

(ii) see SEC v. Calhoun County Medical Facility, Inc., [1981-82] Fed. Sec. L. Rep. (CCH) ¶ 98,243 (D.C. N. Miss. 1981); SEC Release No. 34-17831. (Case sometimes referred to as SEC v. Sklar.)

(iii) Nelson v. Quimby Island Reclamation District Facilities Corp., 491 F. Supp. 1364 (N.D. Cal. 1980); Baron v. Commercial & Industrial Bank of Memphis, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,826 at 95,307-08 (S.D.N.Y. 1979) - both cases discussed below

(iv) will a private cause of action for liability lie against a municipal issuer as a result of the redefinition of "person" in Section 3(a)(9) of the Exchange Act by the Williams Amendments to include a "government, or political subdivision, agency or instrumentality of a government." See In re New York City Municipal Securities Litigation, 507 F. Supp 169, 180-86 (S.D.N.Y. 1980);

(b) Section 17 of Securities Act of 1933, as amended ("Securities Act")

(i) covers municipal issues; unclear whether a private right of action (as opposed to SEC proceeding) can be brought under this section. Cf. In re New York City Municipal Securities Litigation, supra, at 186-87. In Aaron v. SEC, 446 U.S. 680 (1980) court held that negligence (as opposed to scienter) enough for liability under Sections 17(a)(2) and 17(a)(3). See also, S.E.C. v. Haswell, 654 F.2d 698 (10th Cir. 1981).

(c) SEC Report on Role of Underwriter's Counsel, Release No. 17831 June 1, 1981: "Attorney's Conduct in Issuing an Opinion Letter Without Conducting an Inquiry of Underlying Facts Failed to Comport with Applicable Standards of Conduct."

2. State Securities Law Standards

(a) Recently enacted amendments to civil liabilities provisions of Washington Securities Act (RCW 21.20.430) making clear that scienter is required for liability of Washington state and municipal issuers, and their officers and employees, but is not required for recovery against bond counsel or underwriters for material misstatements or omissions.

3. Municipal Finance Officers Association Disclosure Guidelines for State and Local Governments (June 1979 edition).

4. Municipal Securities Rulemaking Board, e.g. Rule G-11 (Sales of New Issue Municipal Securities During the Underwriting Period); Rule G-12 (Uniform Practice); Rule G-15 (Confirmation, Clearance and Settlement of Transactions with Customers); Rule G-23 (Financial Advisor as Underwriter); Rule G-32 (Disclosures in Connection with New Issues); Rule G-33 (Advertisements of New Issues of Municipal Securities). See also MSRB Notice Concerning Application of Board's Rules to Municipal "Commercial Paper". CCH MSRB Manual ¶ 10,200, January 4, 1982.

B. Market Considerations.

1. Apart from federal securities laws, the proper functioning of the capital markets requires disclosure. Competition for available funds requires full and accurate presentation of all material facts concerning borrowers' (e.g. issuers' or industrial obligors') background.

2. The impact of the anti-fraud provisions of the securities laws and the need to present relevant information for the market to evaluate the "credit" are not incompatible. The two concepts "meet" in the Official Statement in public deals and in "access to information" in private placements. Balanced presentation is not only possible but desirable.

3. Are there situations where no amount of disclosure is adequate? As a practical matter, if adequate disclosure is made, market forces should serve to protect investors.

   (a) financing documents supporting bonds are unenforceable. Cf. Chemical Bank v. Wash. Public Power Supply System, et al., 666 P.2d 329 (Wash. 1983) ("take or pay" contracts held ultra vires). See also discussion of "shingle" theory under III.B.2;

   (b) cash flow projections or feasibility study indicates that debt service can't be or is unlikely to be met;

   (c) serious questions regarding tax exempt nature of bonds.

II. Disclosure Documents

A. Official Statement (Public Offering).

1. As a theoretical matter, no legal requirement under federal securities law that there be an Official Statement (but see Rule G-32 of the Municial Securities Rulemaking Board). As a practical matter, may be only effective way to establish that information given customer not misleading. ("A municipality's official statement is central to any system designed to facilitate full disclosure." SEC Final Report, In the Matter of Transactions in the Securities of the City of New York. (February 5, 1979, p. 53).

2. Objectives:

   (a) sales document

   (b) disclosure to limit liability.

3. Format

   (a) MFOA disclosure guidelines;

   (b) similarity to Securities Act prospectus -- although not binding, Securities Act disclosure requirements are instructive (ability to "expertise" certain portions by inclusion of reports of auditors or consultants, e.g. feasibility studies?);

   (c) use of summary statements and introductions;

   (d) placement of disclosure in official statement and clarity of exposition.

4. Preliminary Official Statement

   (a) timing - before Purchase Contract;

   (b) dissemination (cf. Rule 415 - impact on nonregistered transactions?).

5. Final versus preliminary

   (a) what if there is a material change between preliminary and final?

   (b) is it enough if final Official Statement contains change or correction? What circumstances warrant particular emphasis (e.g. by "sticker")?

   (c) effect of a "sticker-out" provision;

   (d) would purchasers have right not to accept delivery or to return securities? See UCC Section 8-319;

   (e) practical - business reasons for pointing out material changes to buyers.

B. Non-Official Statement Disclosures.

1. Private placements - role of access, investigatory responsibilities of buyers (lenders); from disclosure standpoint, principal difference from public offering is the nature and presumed sophistication of the buyers (lenders); consider representation from buyers (lenders) as to access to Schedule A Securities Act type information (mirror image is that buyers (lenders) often ask for representation that industrial obligor has given them all material information).

2. In both public and private transactions, much "disclosure" comes out in representations and closing documentation (which may or may not find its way into an Official Statement in public deals). <u>See</u> discussion of Purchase Contract under III.C.2.

C. What Must be Disclosed.

1. Standard is that of materiality - simply stated, a fact is material if there is a substantial likelihood that a reasonable potential investor would consider it important in deciding whether or not to invest.

2. Material facts relate to both the obligation (bond or note) and the obligor (the issuer; or in the case of industrial development bonds ("IDBs"), the industrial credit; or in the case of hospital bonds, the hospital; etc.)

   (a) with respect to IDBs - for "prime" credits, often incorporate industrial obligor's Exchange Act documents (10K, 10Qs, etc.) by reference (e.g. in Appendix) as opposed to full scale prospectus-type disclosure. Consider desirability of "recent developments" section and interim sales and earnings figures;

   (b) in letter of credit backed, or fully insured, transaction, do you need disclosure re issuer (or, in IDB, company or industrial user)? How much disclosure do you need about letter of credit bank or insuror? <u>See</u> American Banker, June 24, 1982, p. 1, "Standby Letters: An Off-Balance-Sheet Boom". Consider recent financial difficulties of Continental Illinois and United American Bank of Knoxville, Tennessee. Also Baldwin-United Corporation, and resulting disclosure impact regarding issues backed by its AMBAC subsidiary prior to the recent sale of

AMBAC. How is disclosure affected when letter of credit is issued by U.S. branch or agency of a foreign bank? How does collateralization of letter of credit affect analysis?

3. Importance of highlighting risks which may be present in particular financing.

   (a) with respect to traditional municipal general or revenue obligations, examples include ability of issuer to increase or maintain revenues as a practical (as opposed to legal) matter through taxes or fees and charges; debt incurrence ceilings; the economic viability of its industrial base; changing demographics; the integrity of budget projections;

      (i) need for and inclusion of feasibility study in Official Statement; rigorous analysis of assumptions underlying study essential

   (b) with respect to IDBs, examples include risks related to the particular project; risks inherent in the industry; start up nature of industrial obligor. Should there be a discussion of where IDB fits into obligor's other debt? Capitalization table? Description of creditor's rights? Description of material terms of bonds important (e.g. right of obligor to redeem bonds upon obligor's determination of economic "unfeasibility" of project; par call in event of determination of taxability).

4. Selected disclosure topics.

   (a) potential "taxability" (for example, legislation limiting private purpose IDBs);

   (b) rating changes (need to disclose denial of rating?);

   (c) resignation of bond counsel or auditors;

   (d) enforceability of underlying contracts;

   (e) risk of loss of market access.

(f) pending litigation challenging existence of issuer or threatening viability of project. Is a "no merit" opinion enough?

5. Scope of disclosure in connection with remarketing of "put" bonds. Tension between disclosure and reissuance concerns (i.e. need to treat remarketing as secondary market transactions).

D. Who should have primary drafting responsibility? Although technically the issuer's document, underwriter has obvious interest in its accuracy. See Escott v. BarChris Construction Corp., 283 F. Supp. 643, 696 (S.D.N.Y. 1968).

E. Relationship of Official Statement to underwriter's investigatory or "due diligence" duty. See discussion under III.B.

III. Parties Involved in Disclosure and their Respective Roles

A. Bond Counsel.

1. Start-to-finish responsibility: The WPPSS litigation has demonstrated the crucial role of bond counsel at almost every stage of a project financing. It has also refocused attention on the potential for a conflict of interest in the assumption by general counsel to the issuer of the additional role as bond counsel for the issue. What factors determine when this inherent conflict is harmless and when it threatens the integrity of the financing?

2. Final work product results in "legality," "validity" and "tax exempt" opinions without which bonds could not be sold (allegations in WPPSS center on bond counsel's diligence in this regard).

(i) need to qualify bond opinion (for example, during legislative efforts to limit IDBs)

(ii) appropriateness of "evergreen" opinion (e.g., with respect to tax-exempt commercial paper)

(iii) bond counsel increasingly required to render opinions on exemption from registration under the Securities Act of 1933 and from qualification of indenture or resolution under the Trust Indenture Act; also 10b-5

"opinions" or "negative comfort" letters (in WPPSS, questions raised as to bond counsel's treatment of certain material information; see e.g., Chemical Bank v. WPPSS, supra. at 347 (concurring opinion).

3. Prior to rendering opinions extensive preliminary work necessary.

   Examples include:

   (a) determination of appropriate issuers in revenue financings (e.g. state, county, city, local, special purpose or industrial development authorities) and assistance in creating new entities (e.g. joint action agencies) (this was done in the 1950's for WPPSS by local counsel who subsequently served as co-bond counsel);

   (b) examination of existing constitutional and enabling legislation and the drafting of new provisions (need for bond counsel, especially in innovative revenue financings such as joint action agencies, to satisfy itself that financing documents supporting bonds are enforceable -- WPPSS crisis was precipitated by court's holding that "take or pay" contracts of Washington municipal entities were unenforceable);

   (c) determination of limitations on financing (e.g. interest rate limits; restrictions on negotiated sales; use of out of state trustees; debt ceiling limitations; choice of available financing documents such as loan agreements, lease or installment sale; ordinance or resolution publication and "sunshine act" requirements; need for governmental approvals such as certificates of need (in hospital financings) or state finance commissions; restrictions on use of proceeds to pay various costs);

   (d) assistance in any necessary or desirable "test" litigation (bond counsel in WPPSS has been criticized for failing to "validate" contracts through test litigation; considerations involved in determining when and whether test litigation appropriate).

4. Bond counsel generally actively participates in drafting of disclosure documents. Able to utilize its special familiarity with issuer and documentation underlying financing -- uniquely situated to identify for financing team facts or circumstances which warrant prominent disclosure. Can attempts by bond counsel to avoid any responsibility for disclosure documents (i.e. Official Statement) be effective? Under what circumstances is it proper? (Cf. ABA Formal Opinion 346, 68 A.B.A.J. 471-74 (1/29/82) (standards applicable to counsel in delivering tax opinion)).

   (a) are bonds sold on strength of bond counsel's name and reputation? See discussion under III.E.

   (b) bond counsel often functions as counsel to issuer or industrial user (this was the situation in WPPSS). Is there a conflict in such dual representation?

   (c) need to rely on independent local counsel. Ability to practice law in states where not admitted. Should any such reliance be expressly stated in opinion or is it sufficient to have in files as "back-up"?

B. Underwriters.

1. Although municipal issues are exempt from Sections 11 and 12 of the Securities Act, underwriters' liability arises under Section 17 of the Securities Act and Section 10 of the Exchange Act in municipal financings and the standard of diligence is high:

   (a) "It is incumbent on firms participating in an offering and on dealers recommending municipal bonds . . . to make diligent inquiry, investigation and disclosure as to material facts relating to the issuer of the securities and bearing upon the ability of the issuer to service such bonds. It is, moreover, essential that dealers offering such bonds to the public make certain that the offering circulars and other selling literature are based upon an adequate investigation so that they accurately reflect all material facts which a prudent investor should know in order to evaluate the offering

before reaching an investment decision." In re Walston & Co., Inc., SEC Release No. 34-8165, p. 4 (September 22, 1967). Cf. Escott v. BarChris Construction Corp., supra, at 696-97 (discussion of underwriter's due diligence obligations);

(b) in the case of IDB's, Rule 415 and the increased use of Form S-3 by corporate issuers diminish opportunity for underwriters to conduct investigation of corporate users.

2. Competitive Bid vs. Negotiated Transactions.

(a) strictly speaking -- nothing in language of Section 10 or Rule 10b-5 of the Exchange Act or Section 17 of Securities Act leads to the conclusion that there is a different "test" for underwriters' liability in competitive bid situations as opposed to negotiated transactions;

(b) difficulties for underwriters re competitive bid disclosure (query whether WPPSS will or should change diligence practices in competitive bid situations);

(c) problems with the "shingle" ("fraud-on-the-market") theory - would a court hold that an underwriter of bonds, purchased by it in competitive bid, makes implicit representation to its customers as to the issuer (or the company, in the case of industrial development bonds) or the quality of the bonds? Cf. Shores v. Sklar, cited below in Section E.1. Majority opinion in Sklar implicitly supports "shingle" theory but note that case involved negotiated transaction. See also Escott v. BarChris, supra at 696. Court observed that "prospective investors rely upon the reputation of the underwriters in deciding whether to purchase the securities." Cf. T.J. Raney & Sons v. Fort Cobb, Okla. Irrigation Fuel Authority, 717 F.2d 1330 (10th Cir. 1983), cert. denied, ____ U.S. ____, 104 S. Ct. 1285 (1984) (bond counsel's duty regarding validity of bonds); Rose v. Ark. Valley Environmental and Utility Author-

ity, 562 F.Supp. 1180, 1198-1210 (W.D. Mo. 1983) (bond counsel); Grossman, et al. v. Waste Management, Inc. et al., Fed. Sec. L. Rep. (CCH) ¶ 91,550 (N.D. Ill. June 14, 1984) (discussing Shores v. Sklar and T.J. Raney)

(d) considerations re competitive bid disclosure for underwriters -- if after review of notice of sale and Official Statement, and other available information, underwriter feels that security is a "good credit", what does underwriter do if it nonetheless feels there are material gaps, inconsistencies or errors in documents which form the basis of its bid? Among the many considerations which might go into its decision are:

(i) the nature of the possible deficiencies, e.g., is underwriter aware of an error in a debt schedule as opposed to being aware that the statement omits certain demographic data

(ii) financial strength and quality of issuer

(iii) historical relationship with issuer

(iv) can Official Statement be corrected, if not, why?

(v) market factors.

(e) how are these considerations affected by the absence of a "sticker-out" provision in most competitive deals and the consequent ability of the issuer to bind the underwriter to the transaction in the face of post-bid but pre-closing events that materially alter the issuer's position? See, e.g., Roosevelt & Cross, Inc. v. County of Albany, 72 A.D.2d 855 (1979), appeal denied, 49 N.Y.2d 704 (1980).

3. Appropriateness of determining extent of diligence based on size of offering.

4. Can participating underwriters rely on the "due diligence" defense of the lead underwriters? Cf. Competitive Association, Inc. v. International Health Sciences, Inc., [1974-1975 Transfer Binder] Fed. Sec. L. Rptr. ¶ 94,966 (S.D.N.Y. 1975) (holding that since the lead underwriter established its due diligence defense, all underwriters in the syndicate were entitled to the defense).

5. Reliance on others - counsel, auditors, consultants, etc.

C. Underwriters' Counsel.

1. Review of Basic Underlying Documentation

(a) while bond documents (e.g. resolution, indenture, bond form) are primary responsibility of bond counsel, they should be reviewed by underwriter's counsel, as should state constitutional provisions and statutes and federal tax law and regulations relied on for tax exempt status;

(b) industrial revenue bonds

(i) issuer-company documents (e.g. loan agreement; lease; installment sale contract)

(ii) company documents submitted to bond counsel (e.g. specifications for pollution control equipment; documentation for capital expenditures; arbitrage certificates)

(iii) other financing documents (e.g. letter of credit agreements, standby bond purchase agreements, remarketing agreements);

(c) trend toward book-entry/uncertificated security structure (need for understanding of relevant (and evolving) UCC provisions).

2. Purchase Contract (Underwriting Agreement) - primary responsibility of underwriter's counsel

(a) purpose

(i) establish economic terms between issuer and underwriter

(ii) check list for various parties' responsibilities; aid in underwriter's investigatory or "due diligence" obligations,

(b) timing

(i) when signed - not until the underwriter has "priced" the issue

(ii) importance of early draft circulation - so that each party to transaction knows what is required of it at closing;

3. Assist underwriters in "due diligence".

4. Underwriters' counsel's opinions

(a) legal aspect of the opinion;

(b) "negative" comfort (i.e. 10b-5))

(i) should it be in separate letter?

(ii) importance of exclusions (e.g. financial and statistical data)

(iii) period between signing Purchase Contract and Closing

(iv) relationship to underwriters' investigatory or "due diligence" duty;

(c) letter of credit financing has created two areas for opinion, i.e. "bankruptcy" and the enforceability of a letter of credit and any pledge of collateral in support thereof if LOC bank later becomes insolvent or goes into receivership. These are sometimes rendered by underwriters' counsel if issuer or company counsel does not have requisite expertise.

5. Does the standard which underwriters' counsel uses for review differ from standard which it would employ if it were acting as bond counsel or otherwise rendering validity, legality or tax exemption opinions?

D. Other Counsel.

1. Issuer's Counsel [role often performed by bond counsel]

2. Industrial User's (or Company) Counsel

3. Counsel for Trustee

4. Counsel for Rating Agencies

5. Special Tax Counsel

6. Counsel for Letter of Credit (or "put") Bank or Insurer

7. Experts' (e.g. consultant, engineers) Counsel

E. Ethical and Other Legal Standards.

1. ABA Model Rules of Professional Conduct, Rule 1.1 which mandates "competent representation" by a lawyer of his or her client.

2. ABA Committee on Ethics and Professional Responsibility, Formal Opinion 335, Feb. 2, 1974. Counsel writing opinion letters for securities transactions must inquire into "relevant facts", but absent "reasonable cause" the attorney may rely on client's statement of facts.

> "Bond counsel were not expected to investigate the creditworthiness of the City. However, when put on notice of circumstances that called into question matters basic to the issuance of their opinion, bond counsel should have conducted an additional investigation. And bond counsel with knowledge of information material to investors should have taken all reasonable steps to satisfy themselves that those material facts were disclosed to the public." SEC Staff Report, Transactions in Securities of the City

of New York, Chap. 6 -- "The Role of Bond Counsel," pp. 81-82 (August 26, 1977).

3. Restatement 2d of Torts § 299A. See particularly Comment d which argues that a professional who holds himself or herself out as an expert may be required to fulfill a higher standard of care than otherwise required. See in this regard Wright v. Williams, 47 Cal. App. 3d 803, 121 Cal. Rptr. 194 at 199 (1975)

   ". . . a lawyer holding himself out to the public and the profession as specializing in an area of law must exercise the skill, prudence, and diligence exercised by other specialists of ordinary skill and capacity specializing in the same field." and

   See also Walker v. Bangs, 92 Wash. 854, 601 P.2d 1279 (1979).

4. Sommer, The Emerging Responsibilities of the Securities Lawyer, [1973-74] Fed. Sec. L. Rep. (CCH) ¶ 79,631 (January, 1974). Former SEC Commissioner Sommer predicted that "in securities matters . . . the attorney will have to function in a matter more akin to that of the auditor than to that of the advocate."

F. Liability of Counsel for Improper Disclosure.

1. Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (en banc), cert. den., 459 U.S. 1102, 103 S. Ct. 722 (1983). In this 12-10 en banc decision, the Fifth Circuit held that bond counsel (among others) who omitted material facts from an offering circular was liable under 10b-5 to purchasers who never read the circular since the purchasers "reasonably relied on the bonds' availability on the market as an indication of their apparent genuineness . . . ." pp. 469-70. See also T.J. Raney & Sons v. Fort Cobb Okla., Irrigation Fuel Auth.; Rose v. Ark. Valley Environmental and Utility Auth., supra.

2. Nelson v. Quimby Island Reclamation District Facilities Corp., supra; Baron v. Commercial & Industrial Bank of Memphis, supra. These cases reach

contradictory answers to the question whether an opinion letter is a "prospectus."

3. Cronin v. Midwestern Oklahoma Development Authority, 619 F.2d 856 (10th Cir. 1980). Bond counsel is liable to purchasers if they "are shown to have had participation in the issuance of the bonds and thus owed a duty to all the buyers to reveal the facts including the depleted value of the bonds, and if the defendant-lawyers and banks knowingly aided the underwriter in the issuance of value depleted bonds". Id. at 862.

4. Exchange Act Release No. 17,831, [1981] Fed. Sec. L. Rep. (CCH) ¶ 82,874 (June 1, 1981). Concludes that an underwriter's counsel who signed an opinion letter without investigating the underlying facts failed to meet "applicable standards" of professional conduct.

5. SEC v. Calhoun County Medical Facility, Inc., [1981-82] Fed. Sec. L. Rep. (CCH) ¶ 98,243 (N.D. Miss. May 28, 1981); In re Jo M. Ferguson, 5 S.E.C. Docket No. 2 (Sept. 3, 1974). In both cases a consent agreement was entered in which the attorney-defendants agreed to institute certain procedures to prevent future violations of the securities laws.

6. In re Wash. Public Power Supply System Securities Litigation, C-83-232 (W.D. Wash.). The cases involve, among other claims, allegations that bond counsel are liable for rendering opinions as to the validity of Participants' Agreements supporting revenue bonds when courts subsequently held participants lacked authority to enter into agreements (see Chemical Bank v. WPPSS cited above in Section I.B.3.)

IV. What will (should) be the proper response be to the WPPSS debacle regarding the role of counsel and disclosure standards for municipal and agency securities?

A. Administrative response by the MSRB?

1. disclosure standards

2. duty of care

3. conflict of interest

B. Legislative response?

Do recent events warrant a reconsideration of the policies implemented by the Tower Amendment that "states, cities, counties or villages [shall not be subjected] to any unnecessary disclosure requirements promulgated by the [MSRB or the SEC]." 121 Cong. Rec. 10737, 94th Cong. 1st Sess. (1975) (Remarks of Senator Tower).

C. Special disclosure counsel for competitively bid transactions.

EXHIBIT A

AMERICAN BAR ASSOCIATION
MODEL RULES OF PROFESSIONAL CONDUCT

RULE 1.1 Competence

A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

COMMENT:

Legal Knowledge and Skill

In determining whether a lawyer employs the requisite knowledge and skill in a particular matter, relevant factors include the relative complexity and specialized nature of the matter, the lawyer's general experience, the lawyer's training and experience in the field in question, the preparation and study the lawyer is able to give the matter and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question. In many instances, the required proficiency is that of a general practitioner. Expertise in a particular field of law may be required in some circumstances.

A lawyer need not necessarily have special training or prior experience to handle legal problems of a type with which the lawyer is unfamiliar. A newly admitted lawyer can be as competent as a practitioner with long experience. Some important legal skills, such as the analysis of precedent, the evaluation of evidence and legal drafting, are required in all legal problems. Perhaps the most fundamental legal skill consists of determining what kind of legal problems a situation may involve, a skill that necessarily transcends any particular specialized knowledge. A lawyer can provide adequate representation in a wholly novel field through necessary study. Competent representation can also be provided through the association of a lawyer of established competence in the field in question.

In an emergency a lawyer may give advice or assistance in a matter in which the lawyer does not have the skill ordinarily required where referral to or consultation or association with another lawyer would be impractical. Even in an emergency, however, assistance should be limited to that reasonably necessary in the circumstances, for ill considered action under emergency conditions can jeopardize the client's interest.

A lawyer may accept representation where the requisite level of competence can be achieved by reasonable preparation. This applies as well to a lawyer who is appointed as counsel for an unrepresented person. See also Rule 6.2.

Thoroughness and Preparation

Competent handling of a particular matter includes inquiry into and analysis of the factual and legal elements of the problem, and use of methods and procedures meeting the standards of competent practitioners. It also includes adequate preparation. The required attention and preparation are determined in part by what is at stake; major litigation and complex transactions ordinarily require more elaborate treatment than matters of lesser consequence.

Maintaining Competence

To maintain the requisite knowledge and skill, a lawyer should engage in continuing study and education. If a system of peer review has been established, the lawyer should consider making use of it in appropriate circumstances.

Exhibit B

AMERICAN BAR ASSOCIATION

COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 335 **February 2, 1974**

In writing opinions as the basis for transactions involving sales of unregistered securities, a lawyer should make adequate preparation including inquiry into the relevant facts in a manner consistent with the guidelines set out in this opinion, but, while he should not accept as true that which he does not reasonably believe to be true, he does not have the responsibility to "audit" the affairs of his client or to assume, without reasonable cause, that the client's statement of the facts cannot be relied on.

Release #5168 of the Securities and Exchange Commission (SEC) under the Securities Act of 1933 (Release #9239 under the Securities Exchange Act of 1934) was published on July 7, 1971. It set forth certain basic standards of conduct required of broker-dealers to meet their responsibilities in connection with sales of unregistered securities. In a footnote to the next-to-last paragraph of the Release, dealing with the obligation of a broker-dealer to review the surrounding facts and obtain the opinion of competent disinterested counsel concerning the legality of sales, it referred to Securities Act Release #4445 (Securities Exchange Act Release #6721), published on February 2, 1962, in the following manner:

> "In this regard, the Commission has stated that 'if an attorney furnishes an opinion based solely on hypothetical facts which he has made no effort to verify, and if he knows that his opinion will be relied upon as the basis for a substantial distribution of unregistered securities, a serious question arises as to the propriety of his professional conduct.' "

The Commission's repetition of this language led to inquiries of this Committee as to the circumstances under which and the extent to which the Code of Professional Responsibility might require that a lawyer make some effort to verify or supplement the facts submitted to him as the basis for an opinion that certain sales of securities need not be registered under the Securities Act of 1933. The question is of such importance to so many lawyers that this Committee has issued this Formal Opinion in

American Bar Association Committee on Ethics and Professional Responsibility 1155 East 60th, Chicago, Illinois 60637 Telephone (312) 493-0533 *CHAIRMAN:* Lyman M. Tondel, Jr., One State Street Plaza, New York, NY 10004 □ Betty B. Fletcher, Seattle, WA □ Harry Gershenson, St. Louis, MO □ Thomas C. MacDonald, Jr., Tampa, FL □ Harold L. Rock, Omaha, NB □ John F. Sutton, Jr., Austin, TX □ Lewis H. Van Dusen, Jr., Philadelphia, PA □ Sherman S. Welpton, Jr., Los Angeles, CA □ *STAFF DIRECTOR:* C. Russell Twist, 1155 E. 60th St., Chicago, IL 60637

an effort to clarify the existence and extent of a lawyer's responsibility in writing such opinions.[1]

At the outset it should be made clear that we are concerned only with opinions written as the basis for transactions involving sales of unregistered securities. The scope of this opinion does not include legal or other services of lawyers rendered in securities transactions or their participation therein beyond the rendering of such opinions. Furthermore, opinions written in connection with securities registrations or other matters are not within the scope of this opinion. We should also make it clear that, having no specific facts before us and being in a position only to provide guidelines rather than standards, this opinion is not concerned with what constitutes negligence—an issue for the trier of fact under a particular set of facts.

Section 5 of the Securities Act of 1933 broadly prohibits the use of the mails or facilities of interstate commerce to sell a security unless a registration statement is in effect covering such security. However, important exemptions from the requirements of registration are provided, *inter alia*, by Section 4 of the Act, which, as supplemented by rules thereunder, *e.g.*, Rule 144, exempts transactions by an issuer not involving a public offering, transactions not involving an issuer, underwriter or dealer, and certain transactions by dealers and brokers.

Where an exemption is claimed it has been common for the principals to rely on opinions of attorneys who recite the facts, and then say that on the basis of such facts the transaction is entitled to the exemption.

It is, of course, important that the lawyer competently and carefully consider what facts are relevant to the giving of the requested opinion and make a reasonable inquiry to obtain such of those facts as are not within his personal knowledge. Depending upon the circumstances, the

1. The lawyer's proper role, as stated in this opinion, is based upon the Ethical Considerations of the Code. From the standpoint of a mandatory duty enforceable upon the lawyer under the Disciplinary Rules, it is noted that DR 7-102(A)(5) becomes applicable if a lawyer knows that he is making a false statement of law or of fact in the opinion; that DR 7-102(A)(7) becomes applicable if a lawyer, knowing that his client is engaged in illegal or fraudulent conduct, nevertheless counsels or assists the client in that conduct; and that DR 6-101(A)(2) or (3) becomes applicable if the lawyer's conduct in furnishing his opinion involves indifference and a consistent failure to carry out the obligations he has assumed to his client or a conscious disregard for the responsibility owed to his client (see Informal Opinion #1273, dated November 20, 1973). But the responsibility stated in this opinion, measuring the purely ethical obligations of the lawyer, and going further than the mandatory obligations imposed by the Disciplinary Rules, is based upon EC 6-1, EC 6-4, EC 6-5, EC 7-5, EC 7-6, EC 7-8, EC 5-1, and EC 1-5. (See also the fourth paragraph of the Preamble and the fourth paragraph of the Preliminary Statement, Code of Professional Responsibility.)

lawyer may or may not need to go beyond directing questions to his client and checking the answers by reviewing such appropriate documents as are available.

Before going into more detail on the matter of the extent of any required further inquiry, we should point out the importance of avoiding mistakes in communication between the client and the lawyer. In cases turning upon whether or not registration of securities is required, the facts are likely to be important and a lack of proper communication between the client and the lawyer could cause grave difficulties. Therefore, before a lawyer signs an opinion based on facts furnished by his client, he should take reasonable steps to make sure that the client understands exactly what facts he has requested and that he accurately understands what the client has told him.

We turn now to the precise question presented, namely, the circumstances under which, and the extent to which, a lawyer should verify or supplement the facts presented to him as the basis for such an opinion.

In any event, the lawyer should, in the first instance, make inquiry of his client as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in a material respect; or are suspect; or are inconsistent; or either on their face or on the basis of other known facts are open to question, the lawyer should make further inquiry. The extent of this inquiry will depend in each case upon the circumstances; for example, it would be less where the lawyer's past relationship with the client is sufficient to give him a basis for trusting the client's probity than where the client has recently engaged the lawyer, and less where the lawyer's inquiries are answered fully than when there appears a reluctance to disclose information.

Where the lawyer concludes that further inquiry of a reasonable nature would not give him sufficient confidence as to all the relevant facts, or for any other reason he does not make the appropriate further inquiries, he should refuse to give an opinion. However, assuming that the alleged facts are not incomplete in a material respect, or suspect, or in any way inherently inconsistent, or on their face or on the basis of other known facts open to question, the lawyer may properly assume that the facts as related to him by his client, and checked by him by reviewing such appropriate documents as are available, are accurate.

Preliminarily, we state two examples as a means of defining the extremes of the problem in giving an opinion to a securityholder who wishes to sell securities to the public without registration. On the one extreme, if a lawyer is asked to issue an opinion concerning a modest

amount of a widely traded security by a responsible client, whose lack of relationship to the issuer is well known to the lawyer, he may ordinarily proceed to issue the opinion with considerable confidence. On the other extreme, if he is asked to prepare an opinion letter covering a substantial block of a little known security, where the client (be it selling shareholder or broker) appears reluctant to disclose exactly where the securities came from or where the surrounding circumstances raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters, then searching inquiry is called for.

As a further example, suppose that a broker client requests a legal opinion that a proposed sale of shares of X Company would comply with Rule 144, and thus be exempt from registration, and supplies the lawyer with a statement of the facts that allegedly would support such an opinion and a copy of Form 144 proposed to be filed, if any. Assuming that the broker is known to the lawyer to be of good repute, that the lawyer has read the proposed or executed Form 144, if any, and that the alleged facts do not require further inquiry for any of the reasons stated above, the lawyer may properly give the opinion. If on the other hand the alleged facts do require further inquiries for any of the reasons stated above, the lawyer should either make such inquiries until satisfied or refuse to give an opinion if he concludes that reasonable inquiry would still not satisfy him. It is difficult to state a formula for determining how far a lawyer must go to satisfy the requirement that he make a reasonable effort to verify particular facts in such a case. However, it would seem that, for example, the verification from the issuer or its counsel of the number of shares of the class outstanding and the verification (perhaps through financial journals) of the relevant trading volume, an attempt (by checking through a quotation service and/or the relevant "pink" quotation sheets) to determine whether or not the broker is making solicitations of offers to buy the securities, and the inspection of a written statement from the issuer of the securities that it has complied with the reporting requirements mentioned in Rule 144 should normally be sufficient where verification is indicated.

Another example would be where a corporate client requests an opinion as to whether a proposed transaction would be within the private offering exemption furnished by Section 4(2) of the Securities Act of 1933. In this situation, the lawyer should obtain from the client information, preferably in writing, from which the lawyer may reach the legal conclusion that the exemption is (or is not) available. Here again,

the lawyer may properly rely upon the information furnished by a client well known to him, assuming that it is not inconsistent, suspect, otherwise open to question, or incomplete in a material respect.

If the lawyer has some reason to believe that one or more of the statements of fact furnished him as a basis for the opinion may not be correct, he should make a determination as to whether to refuse to give an opinion or whether to attempt to verify one or more of the relevant facts. This matter was discussed in connection with the example dealing with Ruling 144. If he does determine that he will proceed, he should decide on the extent of verification in the light of the particular situation. If, for example, the lawyer has any reason to doubt the reliability of the information relevant to whether the offerees have the requisite sophistication to meet the standard applicable to the Section 4(2) exemption, he should reasonably satisfy himself that the client correctly understands the concept of "sophistication" and he might appropriately obtain from his client further information on each offeree and his background in order to determine that each was sufficiently "sophisticated" to be able to fend for himself and did not need the protection of a registration statement. Where information which may be relevant to a determination of whether or not the exemption provided by Section 4(2) is available may be quite difficult, if not impossible, to verify, it might in fact be necessary to rely completely on the client, but this necessity does not decrease the lawyer's ultimate responsibility to exercise his independent judgment in determining whether the client had a reasonable basis for its determination that each client was sufficiently "sophisticated" and whether, in view of all the facts developed, the Section 4(2) exemption is available. If the lawyer considers that there is any material deficiency in that information, he should simply refuse to give an opinion on the subject.

A properly drafted opinion will recite clearly the sources of the attorney's knowledge of the facts. Where verification is otherwise called for, an attorney should make appropriate verification and should not rely on the use of such phrases as "based upon the facts as you have given them to me" or "apart from what you have told me, I have not inquired as to the facts."

The essence of this opinion, the scope of which has been set forth in the third paragraph, *supra*, is that, while a lawyer should make adequate preparation including inquiry into the relevant facts that is consistent with the above guidelines, and while he should not accept as true that which he should not reasonably believe to be true, he does not have the

responsibility to "audit" the affairs of his client or to assume, without reasonable cause, that a client's statement of the facts cannot be relied upon.

The steps reasonably required of the lawyer in making his investigation must be commensurate with the circumstances under which he is called upon to render the opinion, but he must bear in mind that his responsibility is to render to the client his considered, independent opinion whether, having made at least inquiries such as those suggested by the above guidelines, the claimed exemption is or is not available under the law. While the responsibility of the lawyer is to his client, he must not be oblivious of the extent to which others may be affected if he is derelict in fulfilling that responsibility. A good lawyer is a conscientious lawyer who strives to fulfill, not only the obligations imposed by the Code's Disciplinary Rules, but also the higher responsibilities contained in the Code's Ethical Considerations.

Exhibit C

Securities Exchange Act of 1934 Release No. 17831
(June 1, 1981)

SECURITIES EXCHANGE ACT OF 1934
Release No. 17831/June 1, 1981

ATTORNEY S CONDUCT IN ISSUING AN OPINION LETTER WITHOUT CONDUCTING AN INQUIRY OF UNDERLYING FACTS FAILED TO COMPORT WITH APPLICABLE STANDARDS OF CONDUCT

INTRODUCTION

After consideration by the Commission of the role of the lawyer who represented an underwriter in the public offering of certain industrial revenue bonds, the Commission has determined, in the exercise of its prosecutorial discretion, not to institute an enforcement proceeding against that person, charging aiding and abetting of violations of antifraud provisions of the federal securities laws.[1] This decision not to bring an enforcement action is not based on any conclusion that the lawyer's conduct was even arguably acceptable; to the contrary, the Commission believes that the lawyer failed to carry out his professional obligations under the circumstances described below and, as a result, facilitated violations of the securities laws.[2] The Commission has taken into account certain other factors, including his unfamiliarity with the federal securities laws and the fact that he relied, in a manner inappropriate under the circumstances, upon bond counsel, an experienced securities lawyer. The Commission believes, however, that the public and the bar should be apprised of the conduct of the lawyer in this case and of the Commission's views as to the responsibilities of lawyers who render opinions in connection with securities transactions which affect public investors.

THE FACTS

In 1977, William M. Gotten, an attorney in Memphis, Tennessee, rendered an opinion, as counsel for an underwriter, in connection with the offer and sale of industrial revenue bonds not required to be registered pursuant to the Securities Act of 1933. The opinion letter, which was drafted for Mr. Gotten's signature by bond counsel in the transaction, falsely stated that the offering circular did not "omit to state a material fact necessary to make the statements therein, in the light of the circumstances under which they were made, not misleading".

---

[1] The Commission is issuing this Report in accordance with its authority under Section 21(a) of the Securities Exchange Act. For further information concerning the related civil action filed against others, see Litigation Release No. 9366.

[2] *Ibid.*

Unlike many other industrial bond offerings which are intended to provide funds for the construction of new facilities, the offering in this case was for the purpose of acquiring an existing hospital, which had operated for several years. While the offering circular contained projections of revenues, expenses and earnings, it contained no financial information about the past operations of the hospital. This operating history reflected adversely upon the possibility of future profitable operations and drew into serious question the ability of the issuer to service the debt being issued.

For five years prior to the offering, net income ranged from a loss to a $48,000 profit during a time when the hospital had no mortgage indebtedness or other debt service. Interest expense alone for the first five years of the bond sale was to average about $155,000 per year, or in excess of $100,000 more than the hospital had ever made as profit in the preceding 5 year period. Under a new management company which had operated the hospital during the year immediately preceding the bond offering, with no debt to service, a net profit from operations was realized of only $24,000. Debt service on the new bonds thus required more than $158,000, or an amount equivalent to more than 600% of the hospital's profits during the previous year. This information, clearly both relevant and material to the reasonableness of the income projections, was not disclosed.

Mr. Gotten read the offering circular prior to rendering his opinion. And, although the opinion letter states that the signator has not independently checked or verified most of the material statements in the offering circular, Mr. Gotten, who knew that the issuer was a going concern that had been in operation for a number of years, signed and issued the opinion letter without questioning the omission from the offering circular of financial statements concerning the issuer's prior operating history, reviewing any documents as to the financial status of the issuer, or making inquiry as to results of the operations of prior years.[3] This inquiry was totally inadequate and facilitated the bond closing and the bond sales to the public.

---

[3] In that letter, Mr. Gotten also opined that the bonds were exempt from registration with the Commission under the Securities Act and that compliance with the Trust Indenture Act was not required. Although these opinions turned out to be

DISCUSSION

The nature of services performed by lawyers in connection with securities transactions frequently involves the rendering of opinions concerning compliance by their clients with the federal securities laws. This is so because legal opinions are often essential to the completion of the transactions, and the parties and the investing public look to the opinion as the authoritative statement that the matters opined upon are in order. The importance of the role of counsel who render legal opinions in this context has prompted the bar to establish professional standards for lawyers who provide them. The American Bar Association's Committee on Ethics and Professional Responsibility, for example, has addressed the duties of counsel who render securities law opinions in Formal Opinion 335, 60 A.B.A. Jour. 488 (1974).

Formal Opinion 335 relates to opinions written as the basis for transactions involving sales of unregistered securities and establishes that, as a matter of professional standards, a lawyer must make a preliminary inquiry of the client as to the relevant facts before rendering an opinion as to compliance with the federal securities laws. When the facts obtained from the client appear incomplete or inconsistent with facts known to the lawyer, or are otherwise suspect, the lawyer must make further inquiry.[4] And, if after such further in-

---

FOOTNOTE, Continued

correct, Mr. Gotten had made no attempt to ascertain their applicability or accuracy; instead he relied upon the representations of, among others, the underwriter and bond counsel.

[4] Guidance as to when further inquiry is appropriate is provided in Formal Opinion 335 which states:

> "* * * the lawyer should, in the first instance, make inquiry of his client as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in a material respect; or are suspect, or are inconsistent; or either on their face or on the basis of other known facts are open to question, the lawyer should

quiry, the lawyer is not satisfied as to all the relevant facts, he should refuse to render an opinion.[5]

In addition, Canon 6 of the Model Code of Professional Responsibility of the American Bar Association requires that a lawyer represent his client competently. And Disciplinary Rule 6-101(A) expressly mandates that an attorney shall not handle a legal matter which he knows or should know he is not competent to handle, without associating himself with a lawyer who is competent to handle it, and shall not handle a legal matter without preparation adequate in the circumstances.

The smooth functioning of the securities markets will be subject to serious disruption if the public cannot safely rely on the expertise proffered by lawyers rendering their opinions. Unless lawyers carefully and competently ascertain the relevant facts, and make a reasonable inquiry of their clients to obtain facts not within their personal knowledge, their opinions may facilitate fraudulent transactions in securities. This is so particularly as the investing public looks to the lawyer's opinion as a safeguard against violations of the federal securities laws. As stated by the United States Court of Appeals for the Second Circuit in *Securities and Exchange Commission* v. *Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973), in discussing the conduct of an attorney who, without conducting any inquiry into the underlying facts, issued a false opinion letter that unregistered shares could be sold without registration, "the preparation of an opinion letter is too essential and the reliance of the public too high to permit due diligence to be cast aside in the name of convenience."[6]

> make further inquiry " 60 A.B.A. Jour. at 489.

[5] Again, guidance is provided in Formal Opinion 335 which cautions:

> "Where the lawyer concludes that further inquiry of a reasonable nature would not give him sufficient confidence as to all the relevant facts, or for any other reason he does not make the appropriate further inquiries, he should refuse to give an opinion." *Id.*

[6] *See also United States* v. *Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964) involving an opinion that

The Commission has also stated,

> "if an attorney furnishes an opinion based solely on hypothetical facts which he has made no effort to verify, and if he knows that his opinion will be relied upon as the basis for a substantial distribution of unregistered securities, a serious question arises as to the propriety of his professional conduct."

FOOTNOTE, Continued

certain securities were exempt from registration under Section 3(a)(1) of the Securities Act:

> "In our complex society . . . the lawyer's opinion can be [an] instrument for inflicting pecuniary loss more potent than the chisel or the crowbar. * * * Congress could not have intended that men holding themselves out as members of these ancient professions [the accounting and legal professions] should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess."

And see Securities and Exchange Commission v. *Universal Major Industries, Corp.*, 546 F.2d 1044 (2d Cir. 1976), *cert. denied*, 434 U.S. 834 (1977) (opinion that securities could be sold without registration); *Securities and Exchange Commission* v. *Frank*, 388 F.2d 486 (2d Cr. 1968) (failure of lawyer in drafting a prospectus to make inquiry beyond the facts supplied to him by his client, facts which even a laymen would know were false);

United States v. *Crosby*, 294 F.2d 928 (2d Cir. 1961) (opinion that unregistered stock was freely transferable); *Escott* v. *Barchris Construction Co.*, 283 F. Supp 642 (S.D.N.Y. 1968) (failure to investigate the accuracy of registration statement signed by the attorney); *cf. Securities and Exchange Commission* v. *Coven*, 581 F.2d 1020 (2d Cir. 1978), *cert. denied*, 440 U.S. 590 (1979) (letter representing that a sufficient number of shares had been sold to facilitate the closing of an "all or nothing" offering); *Securities and Exchange Commission* v. *Manor Nursing Centers, Inc.*, 458 F.2d

Securities Act Release No. 4445 (Securities Exchange Act Release No. 6721), published on February 2, 1962 (cited with approval by the Commission in Securities Act Release No. 5168, July 7, 1971).[7]

CONCLUSION

Under the circumstances described above concerning Mr. Gotten's conduct in rendering an opinion letter, and based on the standards of conduct articulated above, the Commission believes that Mr. Gotten's conduct, without having conducted any inquiry of his client as to the underlying facts on which his opinion was predicated, failed to satisfy applicable standards.

By the Commission.

George A. Fitzsimmons
Secretary

1082 (2d Cir. 1972) (failure to correct a misleading prospectus).

[7] In Release No. 4445, the Commission noted the practice of dealers, when attempting to obtain an exemption under Section 4(1) of the Securities Act, of submitting representations to a lawyer that the sellers of the securities did not hold any of those positions that would render the exemption unavailable. The release stated that a lawyer's opinion based on hypothetical facts would be worthless if the facts were not accurate or if the vital facts were not considered. The release further expounded on the duties of responsible counsel to the effect that "it is the practice of responsible counsel not to furnish an opinion * * * unless such counsel have themselves carefully examined all of the relevant circumstances * * *." *Id.*

Exhibit D

James L. SHORES, Jr., as Executor of the Estate of Clarence E. Bishop, Jr., etc., et al., Plaintiffs-Appellants,

v.

Jerald H. SKLAR et al., Defendants-Appellees.

No. 77-2896.

United States Court of Appeals, Fifth Circuit.

May 26, 1981.

Purchaser of revenue bonds issued by industrial development board brought class action seeking to recover upon default on bonds. The United States District Court for the Northern District of Alabama, at Birmingham, James Hughes Hancock, J., entered summary judgment for defendants, and plaintiff appealed. The Court of Appeals, 610 F.2d 235, reversed and remanded. On rehearing en banc, the Court of Appeals, Charles Clark, Circuit Judge, held that: (1) plaintiff failed to state action under Rule 10b-5 based on claim that offering circular contained material misrepresentations and omissions, where he admitted that he never read or otherwise relied on offering circular; (2) even though plaintiff did not read or otherwise rely on statements or omissions in offering circular, charges based on circular's untrue statements or misleading omissions and other allegations that existence of security in marketplace resulted from successful perpetration of fraud on investment community and that plaintiff purchased in reliance on market were sufficient to state claim under rule 10b-5.

Vacated and remanded.

Randall, Circuit Judge, dissented and filed opinion in which Brown, Roney, Gee, Tjoflat, James C. Hill, Fay, Alvin B. Rubin, Reavley and Hatchett, Circuit Judges, joined.

1. Federal Civil Procedure ⟹2547

In considering propriety of summary judgment, plaintiff's factual version must be taken as true. Fed.Rules Civ.Proc. Rule 56, 28 U.S.C.A.

2. Federal Courts ⟹763

Review of dismissal on pleadings alone requires Court of Appeals to determine whether plaintiff could prove any set of facts in support of his claim which would entitle him to relief.

3. Securities Regulation ⟹119

Reliance is an essential element of 10b-5 misrepresentation or omission cause of action. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

4. Fraud ⟹3

Elements of classic misrepresentation action are: defendant must make false representation of material fact, knowing its falsity and intending that plaintiff rely on it, plaintiff must justifiably rely on it, and suffer damage as result.

5. Securities Regulation ⟹143

Defendants may rebut presumption of reliance arising in omission case in which plaintiffs could justifiably expect that defendants would disclose material information, by showing that plaintiff did not rely on defendant's duty to disclose; if plaintiff were to follow same course of conduct even with full and honest disclosure, then defendant's action, or lack thereof, cannot be said to have caused plaintiff's loss. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

6. Securities Regulation ⟹139

Plaintiff failed to state cause of action under Rule 10b-5 based on claim that offering circular contained material misrepresentations and omissions, where he admitted that he never read or otherwise relied on offering circular. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

7. Securities Regulation ⟹119

Even though plaintiff did not read or otherwise rely on statements or omissions in offering circular, charges based on circular's untrue statements or misleading omissions and other allegations that existence of security in marketplace resulted from suc-

cessful perpetration of fraud on investment community and that plaintiff purchased in reliance on market were sufficient to state claim under rule 10b–5. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

8. Securities Regulation ⚫═119

In misrepresentation actions brought under 10b–5 which require separate showing of "transaction causation," test of reliance is whether misrepresentation is substantial factor in determining course of conduct which results in recipient's loss. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

9. Securities Regulation ⚫═143

In 10b–5 action in which plaintiff made allegations that existence of revenue bonds in marketplace resulted from successful perpetration of fraud on investment community and that he purchased in reliance on market, plaintiff's burden of proof would be to show that defendants knowingly conspired to bring bonds into market which were not entitled to be marketed, intending to defraud purchasers, that he reasonably relied upon bonds' availability on market as indication of their apparent genuineness and that as result of scheme to defraud, he suffered a loss. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

10. Securities Regulation ⚫═119

In action under rule 10b–5, requirement that reliance be reasonable or justifiable means only that plaintiff must not intentionally refuse to investigate in disregard of risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

11. Securities Regulation ⚫═117

In action under rule 10b–5, plaintiff must prove that defendants acted with requisite scienter. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

W. Eugene Rutledge, Birmingham, Ala., for plaintiffs-appellants.

George B. Azar, Montgomery, Ala., for Rakerd.

Frank M. Young, III, Meade Whitaker, Jr., Birmingham, Ala., for Cecil Lamberson and Jackson Municipals, Inc.

Hobart McWhorter, Jr., Samuel H. Franklin, Birmingham, Ala., for Capell, Howard, Knabe & Cobbs.

Henry E. Simpson, Birmingham, Ala., for First Alabama Bank of Phenix City.

B. G. Minisman, Jr., Birmingham, Ala., for Asa G. Candler, V.

Crawford S. McGivaren, Jr., Larry B. Childs, Cabaniss, Johnston, Gardner, Dumas & O'Neal, Birmingham, Ala., for defendants-appellees.

Appeal from the United States District Court for the Northern District of Alabama.

Before BROWN, COLEMAN, AINSWORTH, CHARLES CLARK, RONEY, GEE, TJOFLAT, HILL, FAY, RUBIN, KRAVITCH, FRANK M. JOHNSON, Jr., GARZA, HENDERSON, REAVLEY, POLITZ, HATCHETT, ANDERSON, RANDALL, TATE, SAM D. JOHNSON, and THOMAS A. CLARK, Circuit Judges.*

CHARLES CLARK, Circuit Judge:

Clarence E. Bishop, Jr., was one of a number of purchasers of First Mortgage Revenue Bonds of the Industrial Development Board of Frisco City, Alabama ["Bonds"]. The lessee of the industrial business premises, the sole source of the income necessary to amortize the revenue Bonds, almost immediately defaulted in the payment of rent, causing the value of the

* Chief Judge Godbold and Judge Vance were disqualified in this case. Judge Williams does not wish to participate in the decision.

Bonds to drop precipitously.[1] Bishop sued most of those involved with the issuance of the Bonds, alleging that he was the victim of a pervasive scheme to defraud members of the investing public in violation of the securities laws. In essence, the complaint alleged that the defendants had fabricated a materially misleading Offering Circular in order to induce the Industrial Development Board ["Board"] to issue, and the public to buy, fraudulently marketed bonds.[2]

After twice allowing Bishop to amend his complaint, the district court entered summary judgment for the defendants. Based on Bishop's statement in his answers to interrogatories that he never saw nor was he aware of the Offering Circular when he decided to purchase the Bonds, the district court concluded that Bishop had in no way relied on the Circular's alleged misrepresentations or omissions and that his lack of reliance was fatal to his claim. We rehear this case en banc to determine whether a plaintiff must rely specifically on material misrepresentations or omissions in a single disclosure document when, in addition to charges based on its untrue statements or misleading omissions, other allegations would admit proof that the existence of the security in the marketplace resulted from the successful perpetration of a fraud on the investment community and that he purchased in reliance on the market. We hold the securities laws and regulations have a purpose broader than merely criticizing ever-lengthening, complex prospectuses. They cover deliberate, manipulative schemes to defraud which can annul not only the purpose of disclosure but also the market's honest function. Since plaintiff's pleadings would permit such proof, his suit should not have been dismissed at this initial stage. Accordingly, we vacate the judgment of dismissal and remand the case for further proceedings.

I.

[1] During the nearly two years from the time Bishop filed his complaint until the district court entered final judgment, this case did not proceed past the pleading and discovery stage. The court, on the defendants' motions to dismiss, considered matters outside the pleadings, treated the motion as one for summary judgment,[3] and entered judgment for the defendants, because the discovery materials considered showed there to be no genuine issue as to the fact of Bishop's lack of reliance on the Offering Circular. In considering the propriety of summary judgment, plaintiff's factual version must be taken as true. *Bishop v. Wood*, 426 U.S. 341, 347, 96 S.Ct. 2074, 2079, 48 L.Ed.2d 684, 691 (1976); *E. C. Ernst, Inc. v. General Motors Corp.*, 537 F.2d 105, 108 (5th Cir. 1976).

[2] The only fact material to the decision of the district court in dismissing Bishop's complaint was that he did not rely on statements or omissions in the Offering Circular. While that admission correctly controlled the disposition of Bishop's claim that the Circular contained material misrepresentations and omissions (see Part III), we hold its consideration was improper in determining to dismiss his claim based on fraud in bringing the bonds into the marketplace (see Part IV). Therefore, in regard to the latter claim, the dismissal is truly on the pleadings alone. Under *Conley v. Gibson*, 355 U.S. 41, 45, 78 S.Ct. 99, 101, 2 L.Ed.2d 80 (1957), review of the dismissal of this part of the complaint requires us to determine whether Bishop could prove any set of facts in support of his claim which would entitle him to relief.

Reciting the facts most favorably to the plaintiff, as we do below, does not imply that he can prove his allegations.

1. After the sale of the lessee's plant, the identifiable Bond holders received $373.33 per $1000 bond.

2. Throughout the opinion we refer to these Bonds as being "fraudulently marketed." This means the fraudulent scheme alleged by Bishop was so pervasive that without it the issuer would not have issued, the dealer could not have dealt in, and the buyer could not have bought these Bonds, because they would not have been offered on the market at any price.

3. Fed.R.Civ.P. 12(b) and 56.

II.

The bond issue in question had its genesis in 1972 when J. C. Harrelson, president and chief shareholder of Alabama Supply and Equipment Company [ASECo], and Clarence Hamilton, president of Investors Associates of America, Inc., a Tennessee underwriter, decided to seek industrial development financing to construct and equip a facility for the construction of mobile homes in Frisco City, Alabama. Alabama law provides for such financing pursuant to the Wallace-Cater Act, codified in §§ 11-54-80 *et seq.*, Code of Alabama (1975), which authorizes the incorporation of an Industrial Development Board in a municipality in order to induce industry to locate in Alabama. *Id.* § 11-54-81. Such a board has the authority to issue tax-exempt bonds. *Id.* §§ 11-54-87, 11-54-96. With the proceeds of such an issue, a board can build an industrial facility, which it may then lease to a manufacturing, industrial, or commercial enterprise. *Id.* § 11-54-87. The amount of rental payments is calculated to amortize the interest and principal of the bonds and is ostensibly lower than that which could be obtained without tax-free financing.

The Bonds are revenue bonds, not general obligation bonds of the municipality. They must be secured by a pledge of the revenues and receipts from the lease and may be further secured by a mortgage or deed of trust covering the project from which revenues are to be derived. *Id.* § 11-54-90. The municipality is in no event liable for the payment of any of a board's obligations, *id.* § 11-54-92; the sole source for the satisfaction of interest obligations and retirement of principal is the lessee's rent payments. *Id.* § 11-54-89.

Neither Harrelson nor ASECo was a paragon of financial integrity or industrial ability. Harrelson had been only moderately successful in previous business ventures and had little experience in the development of plants for the construction of modular or mobile homes. ASECo's management was inept and unsophisticated, its projections for the sales of mobile homes were mere marketing assumptions, and its financial condition was weak. Indeed, Harrelson and Hamilton both knew that ASECo did not have the financial capability to engage in the manufacture of mobile homes and related products or to pay the rent necessary to amortize the principal and interest on the Bonds. Nevertheless, they determined to induce the Town of Frisco City to create an Industrial Development Board to finance ASECo's facility as a scheme to defraud the investing public.

Hamilton retained defendant Jerald H. Sklar, a Tennessee attorney, as bond counsel. Sklar instructed Investors Associates to conduct an investigation of ASECo and retained John Andrews of Capell, Howard, Knabe & Cobbs, a Montgomery, Alabama, law firm, as bond co-counsel. Andrews saw to the incorporation of the Industrial Development Board of Frisco City and issued an opinion on the legality of the authorization and issuance of the Bonds. Sklar drafted the lease, indenture of trust, mortgage, authorizing resolution, guarantee, and closing papers. The Board entered into a lease with ASECo on November 1, 1972. It required ASECo to pay as base rent the amount necessary to amortize the interest and principal of the Bonds. Harrelson unconditionally guaranteed ASECo's payment of rent under the lease. The Board then adopted the resolution adopting the bond issue. The ability of the Board to meet its financial obligations under the issue depended entirely on ASECo's and Harrelson's financial solvency.

Sklar also drafted the Offering Circular, based on material furnished to him by the underwriter, the lessee company, and those associated with them, but he intentionally or recklessly disregarded other facts of which he was aware. Sklar omitted from the Offering Circular, for example, that the Securities and Exchange Commission had investigated and commenced a civil action against Hamilton and Investors Associates (and against Jackson Municipals, Inc., the assignee who ultimately underwrote the issue) for violations of the securities laws; he even failed to name the underwriter in the

Offering Circular. He misleadingly portrayed ASECo as the owner of 519 acres of Florida real estate valued at $2,284,000, already approved for development, recklessly disregarding not only that ASECo had filed no development plans but also that it had no ownership or equity interest in the property. Although Sklar knew that Harrelson had been only moderately successful at past efforts, he falsely represented Harrelson in the Offering Circular as a successful and experienced developer of modular home manufacturing plans with well-established mobile home sales. Furthermore, Sklar relied on an opinion letter that no actions were pending against or threatening ASECo, even though the opinion letter was obviously deficient and was prepared by a lawyer other than the one originally selected to give an opinion, as Sklar knew. In fact, an action affecting the Florida investment real estate listed on ASECo's balance sheet was pending at the time of the opinion letter.

Part of the information Sklar incorporated into the Offering Circular was a financial statement prepared by George C. Rakard, a certified public accountant from Salem, Illinois. Rakard's financial statement was materially false and misleading because of numerous misrepresentations and omissions. It included as assets of ASECo a number of items of doubtful worth. Open notes and capital stock subscriptions from Harrelson and his wife were valued at $376,000, in reckless disregard of their true value and without taking into account the Harrelsons' probable inability to satisfy these obligations. Three-quarters of the assets were investment properties, including the Florida real estate in which ASECo in fact had no interest. Moreover, Although Rakard's forwarding letter accompanying the financial statement stated that the audit fairly presented the financial condition of ASECo, Rakard knew or recklessly disregarded the fact that the financial statement constituted mere "window dressing" that did not fairly present ASECo's financial condition.

By the time Sklar incorporated Rakard's financial statement into the Offering Circular, he knew or recklessly disregarded the fact that Harrelson was already in default on at least one of the notes listed as an asset of ASECo and that ASECo was in default on its obligation in the lease to maintain at least $400,000 in working capital.

Meanwhile, Investors Associates had determined that it did not possess sufficient capital to underwrite the proposed issue and assigned the right to underwrite the issue to Jackson Municipals, Inc., a Tennessee underwriting firm headed by Cecil Lamberson. Jackson Municipals and Lamberson proceeded to offer the Bonds for sale to the public on the basis of the Offering Circular, even though they knew it contained materially false misrepresentations and omissions. They knew Harrelson was inexperienced and unsophisticated, contrary to the Offering Circular's representation. They purported to rely on Hamilton and Investors Associates, but because they were all defendants in the same SEC action (which the Offering Circular failed to disclose) they knew that Investors Associates needed to induce another firm to underwrite the bond issue or it would lose the value of all the time and effort it had put into the issue thus far.

Lamberson and Jackson Municipals knew that while Harrelson was not as financially secure as represented, 95% of ASECo's current assets consisted of open notes from Harrelson and over 75% of ASECo's listed assets was the Florida real estate, but failed to investigate the true value of either of these assets. They knew that the financial statement did not reflect ASECo's true assets. They even failed to inquire whether Harrelson had paid $200,000 due ASECo on a stock subscription, knowing that ASECo would be in default if Harrelson had not. In spite of this knowledge, Jackson Municipals bought the bond issue from the Board in three increments, commencing on December 14, 1972, and resold the Bonds to securities dealers.

The Phenix National Bank (now the First Alabama Bank of Phenix City, NA) had been chosen to act as trustee of the Bond

proceeds. The Bank's responsibility was to ensure that the lessee complied with the terms and conditions of the lease, one of which was that ASECo at all times have working capital in the amount of $400,000.00 or more. The Bank had the duty to determine the existence of any default in the lease requirements by the lessee, and to demand a cure of the default or else declare the Bonds due and payable upon failure to cure. The Bank's responsibility commenced with the sale of the first increment of the Bonds, which took place on December 14, 1972. The Bank knew or recklessly disregarded from the date its duties as trustee commenced that ASECo was in breach of the lease requirement that it maintain $400,000.00 in working capital.

The Board entered into an agreement with Coliseum Properties, Inc., to construct part of the facilities contemplated by the bond issue. Coliseum Properties, however, merely served as a vehicle by which substantial parts of the proceeds of the issue were diverted and used for the benefit of others. In particular, the controlling persons of the parent corporation of Coliseum Properties, the so-called "Candler defendants," made improper payments to ASECo and to Harrelson in exchange for the construction contract; moreover, Coliseum Properties and some of its officers were under indictment in several pending suits. None of this information was known to the Board when it entered into the agreement with Coliseum Properties.

In January 1973, Bishop spoke with his broker, Tom Monks, president of Professional Securities, Inc., a Birmingham securities dealer, about Bishop's investment possibilities. Monks advised Bishop that tax-free Bonds, such as those issued by the Industrial Development Board of the Town of Frisco City, Alabama, were a good investment and he told Bishop of others in the community who had purchased such Bonds.

Bishop purchased three of the Bonds in January, paying $3,052.67, and one more in February, for $1,043.37. The Offering Circular offered the Bonds for sale at 86, that is for $860 per Bond, yet Bishop paid par—$1,000 plus accrued interest for each Bond. The district court found Bishop purchased as part of the primary offering. However, the record does not disclose whether Bishop purchased directly from Jackson Municipals (and, if so, why the price was not as offered), or from his broker acting as principal or from a seller in the secondary market. Industrial development bonds from towns like Frisco City are not ordinarily traded in a secondary market, but Lamberson stated in deposition that these bonds were being traded, that they were marketable securities, and that his firm had bought and sold some. Indeed, it appears that in addition to its underwriting discount, Jackson Municipals had earned $4,500 by trading these securities in the secondary market. The record is likewise silent as to whether Bishop's purchase was the result of one of these trades.

Bishop never saw the Offering Circular nor knew one existed. He bought the Bonds based solely on his broker's oral representations. At about the same time, he purchased a variety of other municipal bonds offered by various industrial development boards, gas districts, and utility authorities, presumably on similar oral advice from his broker.

After the ASECo plant had been constructed, the lessee ceased all operations at the plant and, on April 15, 1974, defaulted in payment of rent under the lease. Although Harrelson had unconditionally guaranteed the performance of the lease by ASECo, he did not have sufficient assets to back up his guarantee. The Trustee Bank declared the lease in default.

III.

Bishop's original complaint sought relief for himself and for the class of all purchasers of the Bonds under the Securities Act of 1933, 15 U.S.C. § 77a *et seq.*, the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.*, rule 10b-5, 17 C.F.R. § 240.10b-5, and an unspecified Alabama law. The court dismissed all claims under the 1933 Act, which dismissal Bishop does not appeal, but

permitted Bishop to amend his complaint twice in order to allege that he relied on the Offering Circular. Bishop's inability to make such an allegation resulted in the dismissal here on appeal.

[3–5] To the extent that Bishop pleaded the usual 10b–5 misrepresentation or omission case, the district court was correct. Reliance is an essential element of such a cause of action, though the burden of proving or disproving reliance may shift depending on the nature of the case. The elements of a classic misrepresentation action are: (1) the defendant must make a false representation of a material fact, (2) knowing its falsity and intending that the plaintiff rely on it, (3) the plaintiff must justifiably rely on it, and (4) suffer damage as a result. *See* III L. Loss, Securities Regulation 1431 (1961); *Dupuy v. Dupuy,* 551 F.2d 1005, 1014 (5th Cir. 1977). Because reliance is so difficult to prove when a defendant has failed to disclose a material fact rather than misrepresenting it, the Supreme Court has allowed the trier of fact to presume reliance in an omission case where the plaintiffs could justifiably expect that the defendants would disclose material information. *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972). *Ute* did not eliminate reliance as an element of a 10b–5 omission case; it merely established a presumption that made it possible for the plaintiffs to meet their burden. When the *Ute* presumption attaches, the defendant may rebut it by showing that the plaintiff did not rely on the defendant's duty to disclose. If the plaintiff would have followed the same course of conduct even with full and honest disclosure, then the defendant's action (or lack thereof) cannot be said to have caused plaintiff's loss. *See Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 482 F.2d 880 (5th Cir. 1973), *explained in Rifkin v. Crow,* 574 F.2d 256 (5th Cir. 1978).

[6] Bishop alleged that the Offering Circular contained material misrepresentations and failed to state material facts necessary to make the statements made not misleading. At the same time, he admitted that he never read or otherwise relied on the Offering Circular. If the *Ute* presumption applies to these nondisclosures, Bishop's admission rebuts it. Bishop's claim that he was deceived by the misrepresentations and omissions of the Offering Circular was correctly dismissed by the district court because of his failure to read or even seek to read the Offering Circular.

IV.

The district court erred, however, in construing the remainder of Bishop's complaint as narrowly confined to charges of misrepresentations and omissions in the Offering Circular that would have defrauded investors who did rely. It would permit proof that the defendants engaged in an elaborate scheme to create a bond issue that would appear genuine but was so lacking in basic requirements that the Bonds would never have been approved by the Board nor presented by the underwriters had any one of the participants in the scheme not acted with intent to defraud or in reckless disregard of whether the other defendants were perpetrating a fraud. Rather than containing the entire fraud, the Offering Circular was assertedly only one step in the course of an elaborate scheme.

Rule 10b–5 provides in part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, . . .
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Bishop's complaint specifically tracks the language of all three subsections of the

rule.[4] As we have stated in Part III, Bishop's 10b–5(2) claim contained in Count I cannot withstand his admitted lack of reliance on the Offering Circular. However, his 10b–5(1) and (3) claims in Counts I and II assert something more that prevents dismissal at this preliminary stage.

[7] Bishop could prove that he made a general request to his broker to purchase industrial development bonds, that his actual purchases covered a number of different issues, and that he did not undertake to determine which among the issues then offered were the most prudent investments or to second-guess the underwriters in the price and coupon rate they set. His pleadings would permit him to show that he was willing to accept any marketable risk. If a municipal authority was willing to authorize the issuance of the Bond, and the underwriters were willing to present the issue to the market, that was sufficient for Bishop's purposes. His pleadings allow him to show that he sought to make investments in securities which were entitled to be marketed.

[8] It is unnecessary here to decide whether a distinction should be drawn between the terms "loss causation" and "transaction causation." *See Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 384 (2d Cir. 1974) (Frankel, J., concurring). The concept of this scheme to defraud satisfies the requirement of "transaction causation." *Id.* at 381; 1 A. Bromberg & L. Lowenfels, Securities Fraud & Commodities Fraud § 4.7 (558)–(559), at 86.25, 86.32 (1979).[5] It has as its core objective that the potential victim engage in the transaction for which the scheme was conceived. The requisite element of causation in fact would be established if Bishop proved the scheme was intended to and did bring the Bonds onto the market fraudulently and proved he relied on the integrity of the offerings of the securities market. His lack of reliance on the Offering Circular, only one component of the overall scheme, is not determinative. *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975).

[9, 10] Bishop has alleged the necessary elements of an action under 10b–5(1) or (3). In the literal words of rule 10b–5, he must be able to show a "scheme ... to defraud ... or ... [an] act, practice or course of business which operates ... as a fraud or deceit upon [him] ... in connection with the sale of [the Bonds] ...." Bishop's burden of proof will be to show that (1) the defendants knowingly conspired to bring securities onto the market which were not entitled to be marketed, intending to defraud purchasers, (2) Bishop reasonably re-

4. In Count I he states;

In connection with the sale of the Bonds, J. C. Harrelson (now deceased) and others, by the use and means of instrumentalities of interstate commerce and the mails, did or caused the following to be done:

(a) Employed one or more devices, schemes and artifices to defraud Plaintiff and members of the class;

(b) Made to Plaintiff and other members of the class, untrue statements of material fact and omitted to state material facts necessary to be made in order to make the statements made, in the light of the circumstances under which they were made, not misleading in connection with the purchase or sale of the Bonds;

(c) Engaged in acts, practices and courses of business and conduct which operated as a fraud and deceit upon plaintiff and members of the class in connection with the purchase and sale of the Bonds.

In Count II his allegations practically reiterate 10b–5(1) and (3):

In connection with the offer and sale of the bonds, the defendants hereinafter named entered into and participated with J. C. Harrelson in a conspiracy, scheme or agreement to employ devices, schemes and artifices to defraud, and to engage in acts, practices and courses of business which would and did operate as a fraud and deceit upon the Plaintiff and other members of the class sued for herein.

5. Misrepresentation actions brought under 10b–5(2) may require a separate showing of "transaction causation." In such a case, "the test of 'reliance' is whether 'the misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss.'" *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965) (quoting Restatement, Torts § 546 (1938)). Doing away with the conventional reliance requirement in a 10b–5(2) case, therefore, could establish a scheme of investors' insurance.

lied on the Bonds' availability on the market as an indication of their apparent genuineness,[6] and (3) as a result of the scheme to defraud, he suffered a loss.

V.

The thrust of the arguments against our holding is that a recovery in this circumstance is not consonant with the central purpose of the securities laws, which, it is argued, is to provide full disclosure so that investors may make informed investment decisions. It is asserted that allowing recovery to one who has never read the Offering Circular minimizes the importance of such documents and discourages investors from reading them.[7]

We disagree. First, the purposes of the securities acts and rule 10b-5 are far broader than merely providing full disclosure or fostering informed investment decisions. The Supreme Court has held that the acts were designed "to protect investors against fraud and . . . to promote ethical standards of honesty and fair dealing. See H.R. Rep.No. 85, 73d Cong., 1st Sess., 1-5 (1933)." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195, 96 S.Ct. 1375, 1382, 47 L.Ed.2d 668, 677 (1976). This court has held that "[t]he basic intent of section 10(b) and rule 10b-5 and indeed, of the Exchange Act, is to protect investors and instill confidence in the securities markets by penalizing unfair dealings." *Sargent v. Genesco, Inc.*, 492 F.2d 750, 760 (5th Cir. 1974). *See also* *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 91, 93 n.20 (5th Cir. 1975); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 235, 240 (2d Cir. 1974) ("to secure fair dealing"). Thus, the central purpose of the acts is the protection of investors, *Tcherepnin v. Knight*, 389 U.S. 332, 336, 88 S.Ct. 548, 553, 19 L.Ed.2d 564, 569 (1967); *Woodward v. Metro Bank*, 522 F.2d 84, 91 (5th Cir. 1975); *Bellah v. First National Bank*, 495 F.2d 1109, 1111 (5th Cir. 1974); *Herpich v. Wallace*, 430 F.2d 792, 801, 806-08 (5th Cir. 1970), and the promotion of free and honest securities markets. *Id.* The acts reach complex fraudulent schemes as well as lesser misrepresentations or omissions. Full disclosure is only one means, albeit a central one, of achieving these paramount goals.[8]

Second, the role of the Offering Circular will continue undiminished even if Bishop proves his allegations and recovers. He has alleged that the fraud caused the Bonds to be offered for sale on the market. If Bishop proves no more than that the bonds would have been offered at a lower price or a higher rate, rather than that they would never have been issued or marketed, he cannot recover. Thus, a purchaser of securities will still have the strongest incentive to read the disclosure statement if he wants to ensure he gets full value for his securities purchases.

Under Bishop's broader theory, it would have availed him nothing to have read the

6. After *Hochfelder*, *infra*, this circuit's requirement that the reliance be reasonable or justifiable means only that the plaintiff must not "intentionally refuse[ ] to investigate 'in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow.'" *Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir. 1977) (quoting W. Prosser, Law of Torts § 34, at 185 (1971)). Defendants do not suggest that a decision to invest in the municipal obligations of Frisco City, Alabama, without more, constitutes an intentional disregard of an obvious risk.

7. This argument ignores § 11 of the Securities Act of 1933, which allows recovery for untrue statements or omissions of a material fact in the registration statement without proof of reliance. Even when the exception in § 11(a) applies, a plaintiff need not prove that he read the registration statement. Although municipal bonds are exempt from the registration requirements of the 1933 Act, the exemption does not indicate a congressional intent that aggrieved purchasers of municipal bonds must have read an Offering Circular in order to recover. Certainly there are differences between §§ 11 and 12 of the 1933 Act and § 10(b) of the 1934 Act and rule 10b-5. We point to the former provisions only to indicate that Congress did not have a pervasive intent to require plaintiffs under the securities laws to read or rely specifically on a prospectus or circular.

8. The schemes must, of course, be one within the "manipulative" condemnation of the securities law. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977). This one clearly is.

Offering Circular. This theory is not that he bought inferior bonds, but that the Bonds he bought were fraudulently marketed. The securities laws allow an investor to rely on the integrity of the market to the extent that the securities it offers to him for purchase are entitled to be in the market place.

[11] Finally, we reject the contention that our holding imposes new burdens on defendants or enhances their liability. Lawyers, underwriters, and accountants who participate in bond issues in good faith are unaffected by our decision. Liability results only if they act with intent to deceive or defraud. None of these parties may be held liable for mere negligent performance of whatever role they choose to play, for the plaintiff must prove that the defendants acted with the requisite scienter. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976); *Aaron v. SEC*, 446 U.S. 680, 100 S.Ct. 1945, 64 L.Ed.2d 611 (1980).[9]

VI.

The dissent asserts that we adopt a "new theory" because we separate Bishop's claim under 10b–5(2) that the Offering Circular was misleading from his claim under 10b–5(1) and (3) that defendants' fraudulently marketed Bonds caused his loss. It is not our "theory" but the words of rule 10b–5 which confer the right of action we hold Bishop is entitled to try to prove. Contrary to the assertion of the dissent, neither this court nor the Supreme Court has held these parts of the rule do not mean what they say. Misrepresentation and omission cases under 10b–5(2) which, as we do, require reliance on the document making the misrepresentation or omitting a material fact are inapposite to a case in which the buyer relied on the integrity of the market to furnish securities which were not the product of a fraudulent scheme. This circuit has said so,[10] and other circuits have also.[11] There is no Supreme Court precedent to the contrary.

We do not overrule *Rifkin v. Crow*. Rather, we cite it approvingly for the rule 10b–5(2) principle it decides and hold it requires affirmance of the dismissal of that part of Bishop's claim. Moreover, *Rifkin*, is helpful to our holding here in two other respects. It points out that this circuit had not previously decided whether a buyer could rely on a "fraud on the market" theory as developed in the Second and Ninth Circuits.[12] *Rifkin* also explains that our prior decision in *Simon v. Merrill Lynch, Pierce, Fenner & Smith*, (holding the lack of "general reliance" on a stockbroker's misrepresentations foreclosed any right of action) would not apply to such a broader theory of fraud if it were developed on remand. "In other words, *Simon's* 'general reliance' language simply requires there to be a causal link between defendant's violation and plaintiff's harm in order for plaintiff to recover." 574 F.2d 262 n.1.

The dissent asserts that *Affiliated Ute Citizens v. United States*, and *List v. Fashion Park, Inc.*, taken together suggest that Bishop's admitted nonreliance on statements or omissions in the Offering Circular precludes any recovery for harm caused by the broader scheme to bring the Bonds onto the market by fraud. We disagree. *Ute* and *List* emphasized that the role of reliance in securities actions is to establish causation. In *Ute*, silence in the face of a duty by bank employees to disclose self-dealing established "the requisite element of causation in fact." 406 U.S. at 154, 92 S.Ct. at 1472. Furthermore, *Ute* expressly recognized that rule 10b–5 was not limited to dealing with misrepresentation or omis-

9. The Court has yet to decide "whether, under some circumstance, scienter may also include reckless behavior." *Aaron*, 446 U.S. at 686 n.5, 100 S.Ct. at 1950 n.5. This court has decided that it may. *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 535, 545 (5th Cir. 1981); *Thompson & Co., Inc. v. Partridge*, 636 F.2d 945, 959 (5th Cir. 1981).

10. *Rifkin v. Crow*, 574 F.2d 256 (5th Cir. 1978).

11. *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975); *Schlick v Penn Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974).

12. *See* cases cited in footnote 11, *supra*.

sion cases under 10b–5(2), but reached "a 'course of business' or a 'device, scheme or artifice' that operated as a fraud. . . ." 406 U.S. at 153, 92 S.Ct. at 1472. *List* stated that the reason for the reliance requirement "is to certify that the conduct of the defendant actually caused the plaintiff's injury." 340 F.2d at 462. Whenever the rule 10b–5 issue shifts from misrepresentation or omission in a document to fraud on a broader scale, the search for causation must shift also. The "reliance" that produces causation in the latter type of case cannot come from reading a document. It may arise from the duty to speak as in *Ute*, a scheme to manipulate the market at a time when a merger had forced a sale as in *Schlick*, a scheme to inflate common stock prices by misleading statements as in *Rifkin*, or a claim by a bond buyer that he relied on the market to provide securities that were not fraudulently created as we have here. The most significant common thread in all these precedents is that rule 10b–5 is not limited to a narrow right to recover for knowing fraudulent misrepresentations or omissions in disclosure documents which mislead a securities buyer. The rule is recognized also to provide the basis for a federal cause of action for more elaborate, intentional schemes which deceive or defraud purchasers of securities.

The dissent suggests that our holding needlessly imports a state law cause of action for conversion into the federal securities law. Again we disagree. It is the recognized right of action created by rule 10b–5 which we hold Bishop was denied. This cause of action has its roots in congressional enactment, federal regulation and federal precedent. We merely decline to diminish it.

VII.

The judgment dismissing plaintiff's complaint is vacated and the cause remanded for further proceedings not inconsistent with this opinion. The district court also ruled that this action could not be maintained as a class action because of lack of typicality, lack of adequate representation, and lack of a showing that common questions of fact would predominate. All three of these determinations, however, were premised on the belief that reliance on the Offering Circular was crucial to Bishop's claim. On remand, the court must reconsider the maintainability of this action as a class action as to members of a properly defined class of Bond purchasers who did not so rely.[13]

VACATED and REMANDED.

RANDALL, Circuit Judge, with whom BROWN, RONEY, GEE, TJOFLAT, JAMES C. HILL, FAY, ALVIN B. RUBIN, REAVLEY and HATCHETT, Circuit Judges, join, dissenting.

The majority opinion today adopts a new theory of recovery in federal court under Rule 10b–5. It holds that a purchaser of securities offered to the public by means of a misleading offering circular, who has heretofore been foreclosed from recovering in federal court under Rule 10b–5 because of his admitted lack of reliance on the offering circular, will not henceforth be foreclosed from recovering under the Rule if he is able to prove that the defendants knowingly conspired to bring securities onto the market which were not "entitled to be marketed" and that he reasonably relied on the availability of the securities on the market as an indication of their entitlement to be marketed.

This newly-devised route to recovery under Rule 10b–5 is completely without supporting precedent; indeed, it conflicts with the prior decisions of this and every other circuit and with the clear implication of recent Supreme Court decisions in the securities field. But even if the majority were writing on a blank slate, its novel holding would be profoundly unwise for several reasons. First, it introduces into the law under Rule 10b–5 a distinction between securi-

13. The court previously determined the maintainability of a rule 10b–5(2) class action for Bond buyers who could establish reliance on the Offering Circular. The requirement to reconsider the maintainability of an additional class action does not affect that determination.

ties that are "entitled to be marketed," *i. e.*, securities that may be the subject of a fraudulent marketing scheme, but which, absent the fraud, could be sold at *some* price, and securities that are not "entitled to be marketed," *i. e.*, securities that are the subject of a fraudulent marketing scheme and that, absent the fraud, could not be sold at *any* price. The requirements for recovery under Rule 10b–5 in any case hinge upon which category of securities the defrauded plaintiff purchased. If he purchased a security that was entitled to be marketed, he must have relied on the defendants' misrepresentations or omissions in order to recover. If, however, he can show that he purchased a security which was not entitled to be marketed, he can recover in spite of his nonreliance on the defendants' misrepresentations or omissions if he can show that he reasonably relied on the integrity of the marketplace to offer him securities that were entitled to be marketed. This novel theory permits recovery under the Rule to one who has elected not even to seek to read what the seller is obligated by the Rule to disclose, thereby defeating the primary objective of the Rule—the making of an informed investment decision. Second, the majority opinion has great potential for increasing the volume of litigation under Rule 10b–5 by providing a federal forum to those plaintiffs who by their own actions would otherwise have forfeited the protection of the Rule and have relegated themselves to state court actions for conversion. Finally, the majority opinion also has great potential for protracting much Rule 10b–5 litigation that would heretofore have terminated at the summary judgment stage. For these reasons, I respectfully dissent.

I. THE MAJORITY'S TREATMENT OF THE RELIANCE REQUIREMENT

The majority begins part III of its opinion by acknowledging that reliance is an essential element of a misrepresentation or omission case under section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b) (1976). The opinion notes that the trier of fact may presume reliance in an omissions case (as distinguished from a misrepresentations case) in which the plaintiff could justifiably have expected that the defendant would disclose material information. However, that presumption is said by the majority to be rebuttable and is held to have been rebutted in this case by Bishop's admitted failure to read or even seek to read the offering circular.

The majority opinion goes on to distinguish between Bishop's Rule 10b–5(2) case based on misrepresentations and omissions in the offering circular, as to which summary judgment was proper because of Bishop's admitted lack of reliance on the offering circular, and Bishop's Rule 10b–5(1) and (3) case based upon a scheme to defraud and an act that operates as a fraud, each having as its objective the issue and sale of bonds which were not entitled to be marketed. As to the latter case, lack of reliance by the plaintiff on the offering circular, which is described as "only one component of the overall scheme," is held to be not fatal. Instead, proof of reliance by the plaintiff on the availability of the bonds on the market as an indication that they were entitled to be marketed will suffice.

By way of explanation, the majority opinion tells us that the role of reliance in securities actions is to establish causation, and that whenever the issue under Rule 10b–5 shifts from misrepresentations or omissions in a document to "fraud on a broader scale," the search for causation must also shift. In fraud on a broader scale, the reliance that establishes causation "cannot come from reading a document," but instead can consist of reliance on the market to provide securities that are entitled to be marketed. Thus we are told that we need to view Bishop's case as not simply one of the class of cases in which the fraud is accomplished by means of misrepresentations and omissions in an offering circular (in which the absence of reliance by the plaintiff on the offering circular would be fatal to the plaintiff's case) but instead as one in a class of cases involving "fraud on a broader scale" or "more elaborate, inten-

tional schemes which deceive or defraud purchasers of securities" (in which the reliance that is needed is simply reliance on the integrity of the market to provide securities that are entitled to be marketed). We are told this in spite of the fact that Bishop's complaint is *accurately* summarized in the opening lines of the majority opinion as alleging "in essence ... that the defendants had fabricated a materially misleading Offering Circular in order to induce the Industrial Development Board ['Board'] to issue, and the public to buy, fraudulently marketed bonds."

The only direct authority cited by the majority for its novel holding is the Rule itself,[1] which makes it unlawful in connection with the sale of a security to employ any scheme to defraud (clause 1) or to engage in any act which operates as a fraud (clause 3). With deference, I suggest that if it were possible to circumvent the requirement of clause (2) of the Rule of reliance on the defendants' misrepresentations or omissions simply by falling back on the sweeping language of clauses (1) and (3) of the Rule in combination with allegations of elaborate fraud, there would be numerous cases to cite as direct authority for the majority's holding. In fact, there are none.

II. PRIOR PRECEDENT RELATING TO THE RELIANCE REQUIREMENT

A. *The Origins and Function of the Reliance Requirement*

Perhaps the seminal modern case on the reliance requirement is *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811, 86 S.Ct. 23, 15 L.Ed.2d 60 (1965). The gravamen of List's complaint was that the defendants had utterly failed to disclose certain material facts, and that as a result thereof, he had lost money in selling securities.[2] The defendants argued that the language of clauses (1) and (2) of Rule 10b-5 could not support liability in a total nondisclosure case, but the Second Circuit firmly rejected the defendants' suggested distinctions that were based on the differing language of the three clauses; instead, the court relied upon the Rule as a whole for its holding that total nondisclosures fell within the ambit of Rule 10b-5 and section 10(b). *Id.* at 462. Drawing upon the elements of the common law tort of misrepresentation, the Second Circuit incorporated into the private cause of action under Rule 10b-5 the requirement that the plaintiff have relied upon the defendants' misrepresentations or omissions, even in a total nondisclosure case:

> [T]he test of 'reliance' is whether 'the misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss.' ... The reason for this requirement ... is to certify that the conduct of the defendant actually caused the plaintiff's injury....
>
> ....

This interpretation of Rule 10b-5 is a reasonable one, for the aim of the rule in cases such as this is to qualify, as be-

1. In arguing that its holding does not conflict with prior precedent of this circuit or the Supreme Court, the majority virtually concedes that there is no direct *precedential* support for its interpretation of clauses (1) and (3) of the Rule: "It is not our 'theory' but the words of rule 10b-5 which confer the right of action we hold Bishop is entitled to try to prove. Contrary to the assertion of the dissent, neither this court nor the Supreme Court has held [that] these parts of the rule do not mean what they say." *Ante*, 647 F.2d at 471.

2. In *List*, the plaintiff was an experienced and successful investor who had purchased 5,100 shares of Fashion Park stock in 1959 at $13.50 per share. In November 1960, with the advice of his broker, List authorized the sale of his stock at a net price to him of not less than $18 per share. List's broker knew that at that time, two directors of Fashion Park were bidding for Fashion Park stock through the pink sheets, but the broker did not think it important to disclose this fact to List, and List made no effort to learn whether the directors were in the market for the stock. Another development was the adoption of a resolution by the board of directors of Fashion Park on November 4, 1960, to merge into another company. Fashion Park did not issue a press release about the merger. List sold his stock in mid-November 1960, at $18.50 per share, without knowing that one of Fashion Park's directors was the purchaser or that Fashion Park's management was considering the sale of the company.

tween insiders and outsiders, the doctrine of caveat *emptor*—not to establish a scheme of investors' insurance. Assuredly, to abandon the requirement of reliance would be to facilitate outsiders' proof of insiders' fraud, and to that extent the interpretation for which plaintiff contends might advance the purposes of Rule 10b–5. But this strikes us as an inadequate reason for reading out of the rule so basic an element of tort law as the principle of causation in fact.

Id. at 462–63 (bracketed portion inserted by Second Circuit). In applying this principle to the case before it, the Second Circuit held that the trial court's detailed findings of fact, to the effect that List would have sold his stock even had he been aware of the undisclosed information, were not clearly erroneous; accordingly, the showing of causation necessary to support a private recovery under Rule 10b–5 was missing, and List could not recover.

This court promptly adopted the rule of *List*. *E. g., Herpich v. Wallace*, 430 F.2d 792, 806 & n.12 (5th Cir. 1970) (citing *List*); *Grumbles v. Times Herald Printing Co.*, 387 F.2d 593 (5th Cir.), *cert. denied*, 390 U.S. 1028, 88 S.Ct. 1419, 20 L.Ed.2d 285 (1968) (affirming per curiam a judgment for defendant on basis of adequately supported jury findings that plaintiff did not rely and that omitted facts were not material).

B. *Modifications to the Manner in Which the Reliance Requirement May Be Satisfied*

Subsequent to the *List* decision, the federal courts have developed two modifications in the manner in which reliance may be established, both of which are aimed at overcoming what would otherwise be virtually insurmountable obstacles for plaintiffs. The first modification applies only to nondisclosure cases—*i. e.*, those cases in which the defendants have remained silent in the face of a duty to disclose. The second modification applies only to certain "fraud on the market" claims—typically class actions in which a great many plaintiffs have allegedly suffered losses in the secondary trading market as a result of misrepresentations or omissions in a series of documents promulgated by the defendants over a period of time.

1. The rebuttable presumption of reliance in total nondisclosure cases.—In many instances, the violation of Rule 10b–5 complained of by the plaintiff is a total failure to disclose material information, as was true in *List*. Early in the 1970s, the federal courts increasingly became aware that in such total nondisclosure cases, a plaintiff faces almost an insurmountable burden if he is required to present affirmative evidence that he relied specifically on the defendants' silence with regard to a material fact.

The Supreme Court first addressed this problem in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972). The defendants in *Affiliated Ute*, who were marketmakers in the stock of a company holding assets for certain Indians, as well as sales agents for the Indians, had remained silent as to prevailing market prices for the stock in circumstances in which they had a duty to disclose those prices. The Indians "considered these defendants to be familiar with the market for the shares of stock and *relied upon them* when they desired to sell their shares." *Id.* at 152, 92 S.Ct. at 1471 (emphasis added).[3] The Supreme Court held that the Tenth Circuit had

> erred when it held that there was no violation of the Rule unless the record disclosed evidence of reliance on material fact misrepresentations by [the defendants]. We do not read Rule 10b–5 so restrictively. *To be sure, the second subparagraph of the rule specifies the making of a untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted.* These defendants'

3. *See also Chiarella v. United States*, 445 U.S. 222, 229–30, 100 S.Ct. 1108, 1115, 63 L.Ed.2d 348 (1980) (including, in a description of *Affiliated Ute*, a reference to the reliance by the Indian sellers upon the Bank's personnel).

activities, outlined above, disclose within the very language of one or the other of those subparagraphs, a "course of business" or a "device, scheme, or artifice" that operated as a fraud upon the Indian sellers. *Superintendent of Insurance v. Bankers Life & Casualty Co.*, [404 U.S. 6, 92 S.Ct. 165, 30 L.Ed.2d 128] (1971)].... The sellers had the right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price in that market....

> *Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery.* All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.... This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

Id. at 152–54, 92 S.Ct. at 1471–1472 (emphasis added; some citations omitted).

The courts of appeals have not read *Affiliated Ute* as having done away with the reliance requirement altogether. Rather, *Affiliated Ute* has been read to establish a rebuttable presumption that the plaintiff relied upon the defendant's silence in total nondisclosure cases, at least so long as the facts as to which the defendants were silent meet the materiality requirement. For example, in *Rifkin v. Crow*, 574 F.2d 256 (5th Cir. 1978), the law in this circuit on reliance was carefully summarized and restated, with special attention paid to *Affiliated Ute*:

> After *Ute*, the reliance requirement has varied somewhat in articulation from circuit to circuit, but a general pattern seems to have emerged: where a 10b–5 action alleges defendant made positive misrepresentations of material information, proof of reliance by the plaintiff upon the misrepresentation is required. Upon an absence of proof on the issue, plaintiff loses. On the other hand, where a plaintiff alleges deception by defendant's nondisclosure of material information, the *Ute* presumption obviates the need for plaintiff to prove actual reliance on the omitted information. Upon a failure of proof on the issue, defendant loses. But this presumption of reliance in nondisclosure cases is not conclusive. *If defendant can prove that plaintiff did not rely, that is, that plaintiff's decision would not have been affected even if defendant had disclosed the omitted facts, then plaintiff's recovery is barred.*

Id. at 262–63 (footnotes omitted). *Accord, Huddleston v. Herman & MacLean*, 640 F.2d 534, 547–50 (5th Cir. 1981) ("reliance is an issue in *all* Rule 10b–5 cases"); *Dwoskin v. Rollins, Inc.*, 634 F.2d 285, 291 n.4 (5th Cir. 1981); *Moody v. Bache & Co.*, 570 F.2d 523, 528 (5th Cir. 1978); *Vohs v. Dickson*, 495 F.2d 607, 622 (5th Cir. 1974); *Rochez Brothers, Inc. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1974); *Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 482 F.2d 880, 884–85 (5th Cir. 1973). Indeed, until today, this circuit has uniformly required not only that there have been reliance (whether established by means of an unrebutted presumption under *Affiliated Ute* or proved directly by the plaintiff), but also that the plaintiff's reliance have been *reasonable*.[4]

4. Judge John Minor Wisdom, writing for our court in *Dupuy v. Dupuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 911, 98 S.Ct. 312, 54 L.Ed.2d 197 (1977), summarized the elements of a private cause of action under Rule 10b–5:

> The courts have established that with regard to private recovery for the violation of rule 10b–5, a properly stated cause of action must establish the scienter of the defendant, the materiality of any misrepresentation or omission by the defendant, *the extent of actual reliance by the plaintiff on the defendant's statements, and the justifiability of the reliance*, frequently translated into a requirement of due diligence by the plaintiff.

Id. at 1014 (emphasis added; footnotes omitted). The argument made in *Dupuy* was that because *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), required that the plaintiff prove scienter as part of his cause of action, the plaintiff's lack of diligence in investigating the information available to him should not defeat recovery because the defendant's culpability would be of a far greater degree. The *Dupuy* court rejected this argument, however:

The majority opinion does not purport to overrule any of these cases. Indeed, it specifically disclaims any intent to overrule *Rifkin* by treating it as a case arising only under clause (2) of Rule 10b–5. Admittedly, the opinion in *Rifkin* does not make an explicit distinction between cases arising under clause (2) of the Rule and those arising under clauses (1) and (3). But *Rifkin* does make a clear distinction between misrepresentation and omission cases, and its holding as to the latter is premised on *Affiliated Ute* (which was itself a holding under clauses (1) and (3)). This leads me to believe that in *Rifkin* and its progeny this court has spoken to the question of whether proof of nonreliance bars recovery in a case arising under clauses (1) and (3)—and has held that it does. *Huddleston v. Herman & MacLean, supra*, reads *Rifkin* in this manner.

Further, the majority opinion squarely conflicts with the decision of the Eighth Circuit in *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713 (8th Cir. 1978). Although the majority chooses not to discuss *Vervaecke*, that case also involved an initial public offering of bonds and featured a plaintiff who, by his own admission, had not relied on a defective offering circular. Sensing that his admission might be fatal to a clause (2) claim, he urged that his case should be considered as one involving primarily nondisclosure cognizable under clauses (1) and (3) of Rule 10b–5. The Eighth Circuit specifically declined to do so and held instead that the district court had properly granted summary judgment for the defendants because of the plaintiff's admitted nonreliance on the offering circular.

Regardless of whether the majority opinion conflicts directly or only indirectly with the cases discussed above, it is clear at least that *none* of these prior cases dealing with the reliance requirement even indirectly supports the majority's holding today. If those cases are not explicitly overruled, I believe that for the reasons expressed below in part III, their practical vitality has been emasculated *sub silentio* by the majority.

2. *Reliance in "fraud on the market" class actions.*—In insisting that it is not overruling *Rifkin v. Crow*, the majority notes in part VI of its opinion that *Rifkin* "points out that this circuit *had not previ-*

[T]o abandon completely the consideration of reliance in fact and reasonable reliance ignores not only the above[-stated] policies of due diligence but also the need for a causal link between the misrepresentation or omission and the injury suffered by the private plaintiff. The cause of action would no longer provide compensation for losses occasioned by the violation of the [1934] Act because a plaintiff could sue without relying on the fraud. This would transform the action into an enforcement mechanism. We reject this approach . .

Id. at 1016. The court did agree, however, that *Hochfelder* called for a modification of the standard of care under which the plaintiff's conduct would be judged—*i. e.*, a modification that would broaden the definition of "reasonable" reliance. Backing away somewhat from our previous definition of reasonableness, as expressed in cases such as *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 103–04 (5th Cir. 1970), cert. *denied*, 402 U.S. 988, 91 S.Ct. 1660, 29 L.Ed.2d 153 (1971), the *Dupuy* court held that mere negligence was not enough to make the reliance unreasonable; instead, to defeat recovery on grounds that the plaintiff's reliance was unreasonable, the plaintiff's conduct must have been a refusal to investigate in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow. 551 F.2d at 1020.

This court has steadfastly adhered to *Dupuy's* requirement that the plaintiff's reliance have been reasonable—*i. e.*, within the standard of care articulated by the *Dupuy* court. *See, e. g., Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1121–22 (5th Cir. 1980) (Charles Clark, J.); *Swenson v. Engelstad*, 626 F.2d 421, 424 (5th Cir. 1980).

The majority points out that there has been no allegation in this case that Bishop lacked due diligence. *Ante*, 647 F.2d at 470 n.6. But since there was positive proof of Bishop's *nonreliance*, there is simply no issue as to the reasonableness of Bishop's reliance.

Nonetheless, *Dupuy* and its progeny are extremely relevant to our inquiry: Judge Wisdom's reasoning, in rejecting the argument that the reasonableness of the plaintiff's reliance should not be a part of his cause of action, is equally applicable in this case, where the majority dispenses not with the requirement that the plaintiff's reliance be reasonable, but with the more fundamental requirement that he have relied in the first place.

ously decided whether a buyer could rely on a 'fraud on the market' theory as developed in the Second and Ninth Circuits."[5] In an accompanying footnote, the majority cites *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976, 95 S.Ct. 1976, 44 L.Ed.2d 467 (1975), and *Blackie v. Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816, 97 S.Ct. 57, 50 L.Ed.2d 75 (1976). *Schlick* is not a "fraud on the market" case in the usual sense of that term, but as discussed below in part II–C, it represents another sort of modification to the reliance requirement. *Blackie*, however, is the seminal and best known of the "fraud on the market" cases. Earlier, in part IV of its opinion, the majority cites *Blackie* for the proposition that Bishop's "lack of reliance on the Offering Circular, only one component of the overall scheme, is not determinative."[6] The inference is that the majority believes that *Blackie* and the other "fraud on the market" cases support its holding in the case at bar.

Blackie is typical of the "fraud on the market" cases in that it involved an extremely large class of plaintiffs who purchased the securities of an issuer at different times over an extended period. The gravamen of the claims of all members of the putative class was the alleged misrepresentation by the issuer of its true financial condition in annual and interim reports, press releases, and SEC filings. One ground upon which the defendants resisted the named plaintiffs' motion for class certification was that the need for direct proof of subjective reliance by each class member would inevitably create sufficient conflicts between class members and the named plaintiffs as to make the named plaintiffs' representation inadequate.

The Ninth Circuit recognized that it was virtually impossible in the context of classwide proceedings for each class member to present direct proof of his subjective reliance.[7] The court therefore established a rebuttable presumption for those cases alleging deception that inflated the price of stock traded on the open market:

> [P]roof of subjective reliance on particular misrepresentations is unnecessary to establish a 10b–5 claim for a deception inflating the price of stock traded in the open market. Proof of reliance is adduced to demonstrate the causal connection between the defendant's wrongdoing and the plaintiff's loss. We think causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causational chain between defendant's conduct and plaintiff's loss is sufficiently established to make out a prima facie case.

Id. at 906 (citations omitted). Drawing upon a distinction made by the Second Circuit in *Schlick* between "loss causation" and "transaction causation," the Ninth Circuit specifically rejected the notion that a Rule 10b–5 action can be predicated solely on a showing of loss causation:

> The 10b–5 action remains compensatory; it is not predicated solely on a showing of economic damage (loss causation). We merely recognize that individual "transactional causation" can in these circumstances be inferred from the materiality of the misrepresentation, *see Tucker v. Arthur Andersen & Co.*, [67 F.R.D. 468, 480 (S.D.N.Y.1975)]; *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 381–382 (2d Cir. 1974), and shift to defendant the burden of disproving a prima facie case of causation. Defendants may do so in at least 2 ways: 1) by disproving materiality

5. *Ante*, 647 F.2d at 471 & n.12. *Rifkin* lists a number of "fraud on the market" cases in addition to *Blackie*. *See* 574 F.2d at 263 n.4.

6. *Ante*, 647 F.2d at 469.

7. *Cf. Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981) ("in a class action, while the materiality element can be established for the class as a whole, reliance, like damages, is a matter of individual proof").

or by proving that, despite materiality, an insufficient number of traders relied to inflate the price; and 2) *by proving that an individual plaintiff purchased despite knowledge of the falsity of a representation, or that he would have, had he known of it.*

Id. (footnote omitted; emphasis added).

Blackie's significance to the case at bar rests in its holding that despite a presumption of reliance in "fraud on the market" cases, the defendant may still defeat recovery by positive proof of nonreliance. The Ninth Circuit has consistently adhered to this rule. *E. g., Keirnan v. Homeland, Inc.*, 611 F.2d 785, 788–89 (9th Cir. 1980). Thus, *Blackie* provides absolutely no support for the majority's partial abandonment of the reliance requirement.

C. *The Limited Circumstances in Which Reliance May Be Unnecessary*

My own research reveals only one factual situation in which the reliance requirement arguably would be unjustified. That situation was presented in *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976, 97 S.Ct. 57, 50 L.Ed.2d 75 (1975)—a case cited by the majority in connection with a distinction between "loss causation" and "transaction causation." [8]

Schlick did not allege fraud resulting in his purchase of a security; instead, he alleged that a fraudulent proxy statement was one step in a scheme that led to the forced liquidation of his security.[9] The Second Circuit noted that this was *not* a typical Rule 10b–5 case:

> This is not a case where the 10b–5 claim is based solely upon material omissions or misstatements in the proxy materials. Were it so, concededly there would have to be a showing of both *loss causation*—that the misrepresentations or omissions caused the economic harm—and *transaction causation*—that the violations in question caused the appellant to engage in the transaction in question. The former is demonstrated rather easily by proof of some form of economic damage, here the unfair exchange ratio, which arguably would have been fairer had the basis for valuation been disclosed. Transaction causation requires substantially more.

507 F.2d at 380 (emphasis in original; footnote omitted). The court went on to explain the two ways in which a plaintiff could make a prima facie showing of transaction causation:

> In a misrepresentation case, to show transaction causation a plaintiff must demonstrate that he relied on the misrep-

8. *Ante*, 647 F.2d at 469.

9. Plaintiff Schlick was a minority shareholder in Continental Steel; defendant Penn-Dixie had become a majority shareholder in Continental and thus had voting control. Schlick alleged that Penn-Dixie, by causing Continental's assets to be used for its own purposes, artificially depressed the market price of Continental stock and inflated the market price of Penn-Dixie stock. Schlick alleged that, as part of a scheme, Penn-Dixie proposed to merge Continental into a Penn-Dixie subsidiary but failed to disclose in the proxy statement issued before the merger the manner in which Penn-Dixie had inflated the value of its shares at the expense of Continental. Penn-Dixie then merged Continental into a subsidiary, with the result that the minority shareholders in Continental received an unfairly low exchange ratio. Significantly, Continental's minority shareholders had no power to prevent the merger. Under state law a majority of the outstanding shares was all that was required in order to effect the merger. The exchange of the Continental shares held by Schlick and the other minority shareholders for those of the Penn-Dixie subsidiary was, effectively, a forced sale in which they made no investment decision. Schlick's class action, which was founded upon sections 10(b) and 14(a) of the 1934 Act, and Rules 10b–5 and 14a–9 thereunder, was dismissed by the district court on the ground that it failed to present any allegation of injury which was *caused* by the allegedly false and misleading proxy statement other than that caused by the unfair merger itself. After reviewing the allegations of the complaint and the decision of the district court, the Second Circuit noted that the nature of the fraud alleged in the complaint—engagement in a course of business which operated as a fraud and deceit on the purchasers and holders of Continental stock—was encompassed by clause (3) of Rule 10b–5.

resentations in question when he entered into the transaction which caused him harm. . . . In an omission or nondisclosure case based upon Rule 10b–5, a plaintiff need not show reliance in order to show transaction causation but must still show that the facts in question were material "in the sense that a reasonable investigator might have considered them important" in making his investment decisions.

Id. As an exception to the general proposition that a plaintiff must allege and prove transaction causation to recover under Rule 10b–5, the court carved out a limited exception:

> Under the 10b–5 count, *proof of transaction causation is unnecessary by virtue of the allegations as to the effectuation of a scheme to defraud which includes market manipulation and a merger on preferential terms*, of which the proxy omissions and misrepresentations are only one aspect. Thus appellant need only show loss causation with respect to his claim for relief under 10b–5; [the court below] found and we agree that this has been shown. Here the complaint clearly alleges that, *as a result of the merger, appellant was forced to sell* his Continental shares to Penn-Dixie on the basis of an exchange ratio that reflected adversely the manipulated market value of Continental stock, and that he sustained injury accordingly.

Id. at 381 (emphasis added).

Schlick, then, did not even arguably fit within clause (2) of Rule 10b–5. The misrepresentations and omissions in the proxy statement did not cause the plaintiff's loss. Instead, the claim involved, to paraphrase the Second Circuit's opinion, a forced sale in which the plaintiff had no opportunity to make an *investment decision* and in which, therefore, the defendants' misrepresentations and omissions in the proxy statement were not the sole mechanism—or even the *key* mechanism—through which the fraudulent scheme was to be accomplished. The object of the scheme was not to induce the minority stockholders to make an erroneous decision based on the misstatements and omissions in the proxy statement, for their decision on the proxy solicitation was irrelevant to the success of the scheme; rather, those misstatements and omissions were part of the alleged plan to cover up the essence of the fraud, which was the manipulation of stock prices to set the scene for an unfair exchange ratio in a forced merger. Transaction causation was irrelevant because the minority shareholders were not called upon to make an investment decision. The specific holding of the *Schlick* case, then, can be summarized as follows: when a plaintiff alleges that he has sustained a loss as the result of a fraudulent scheme to bring about a forced sale of his security, he need not plead or prove transaction causation (including reliance, actual or presumed) because he has made no investment decision to participate in the transaction. *Accord, Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 797 (2d Cir. 1969), *cert. denied*, 400 U.S. 822, 91 S.Ct. 41, 27 L.Ed.2d 50 (1970) ("where the success of a fraud does not require an exercise of volition by the plaintiff, but instead requires an exercise of volition by other persons, there need be no showing that the plaintiff himself relied upon the deception"); *Vine v. Beneficial Finance Co.*, 374 F.2d 627, 635 (2d Cir.), *cert. denied*, 389 U.S. 970, 88 S.Ct. 463, 19 L.Ed.2d 460 (1967) ("[w]hatever need there may be to show reliance in other situations [citing *List* and other cases], we regard it as unnecessary in the limited instance when no volitional act is required and the result of a forced sale is exactly that intended by the wrongdoer").

Though the specific holding in *Schlick* obviously is inapplicable given the facts of the case at bar, the portion of the Second Circuit's opinion dealing with loss causation and transaction causation *is* instructive. Ours is a case in which, to quote the majority opinion, "the complaint alleged that the defendants had fabricated a materially misleading Offering Circular in order to induce

the Industrial Revenue Board to issue, and the public to buy, fraudulently marketed bonds." [10] Whether this case is viewed as a misrepresentations case or an omissions case,[11] the named plaintiff and every member of the putative class voluntarily entered into the transaction as the result of an investment decision. If we adhere to *Schlick*, each must show transaction causation—including reliance (actual or presumed) on the offering circular. In this case the existance of reliance has been definitively disproved by Bishop's admission that he did not read or even seek to read the offering circular. And, as the majority opinion correct concludes, presumptive reliance has been rebutted by the same admission.

In short, neither *Schlick*, *Blackie*, nor any other case cited by the majority supports its holding. In fact, the majority's holding runs contrary to the clear implication of every case from this circuit and others in which the reliance requirement has been considered.

III. REASONS FOR ADHERENCE TO THE RELIANCE REQUIREMENT

A. *The Policy Behind the Reliance Requirement*

In the case at bar, the majority holds that nonreliance on the defendants' misrepresentations or omissions is not fatal to some cases brought under clauses (1) and (3) of Rule 10b-5 and creates instead a new sort of reliance requirement for those cases—reliance on the integrity of the marketplace. Other than the majority's interpretation of the policies and the congressional purpose behind the federal securities laws,[12] there is absolutely no support for the majority's holding today in the prior precedent of this or any other court.

In part V of its opinion, the majority correctly states that "[t]he thrust of the arguments against [its] holding is that a recovery in this circumstance is not consonant with the central purpose of the securities laws, which, it is argued, is to provide full disclosure so that investors may make informed investment decisions." [13] The majority then cites phrases from a number of cases [14] for the proposition that "[f]ull dis-

10. *Ante*, 647 F.2d at 464 (footnote and bracketed definition of terms omitted).

11. In my view, this is primarily a misrepresentations case rather than an omissions case because the defendants undertook to sell the bonds pursuant to an offering circular. *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 548 (5th Cir. 1981) ("[t]his case, involving alleged misstatements and omissions in a prospectus published pursuant to a public offering, cannot properly be characterized as an omissions case of the type for which the *Affiliated Ute* presumption was fashioned"); *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713, 717 n. 2, 718 & n. 4 (8th Cir. 1978).

12. Justice Rehnquist's opinion in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975), emphasizes the importance of weighing competing policy concerns:

> [W]e would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express "intent of Congress" as to the contours of a private cause of action under Rule 10b-5. When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. Such growth may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it, . . . but it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5. It is therefore proper that we consider . . . what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.

Id. at 737, 95 S.Ct. at 1926.

13. *Ante*, 647 F.2d at 470; MS at 16.

14. The complete quote from *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), reads as follows:

> The Securities Act of 1933 (1933 Act), 48 Stat. 74, as amended, 15 U.S.C. § 77a *et seq.*, was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing. See H.R.Rep.No.85, 73d Cong., 1st Sess., 1-5 (1933). The 1934 Act was intended principally to protect investors against manipulation of stock prices through regula-

closure is only one means, albeit a central one, of achieving [the] paramount goals" of the federal securities laws.[18] I disagree.

Although passed largely in response to the paralyzing financial crises of the period, the securities laws enacted by Congress in the 1930s were not intended to create a scheme of investors' insurance or to regulate directly the underlying merits of various investments. Compared to the consumer-oriented legislation of the late 1960s and 1970s, the federal securities laws leave a great many potential "harms" (in the sense of economic losses by individual investors) unremedied. In marked contrast to federal laws in other fields, and to many state "blue sky" securities laws, the federal securities laws are based on the premise that the federal government's role is merely to ensure the free flow of complete and accurate information within the Nation's securities markets; once full disclosure is achieved, individual investors are expected to look out for their own interests. In *Affiliated Ute*, the Supreme Court described the 1934 Act and its companion legislative enactments (including the Securities Act of 1933) as embracing a "fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and *thus to achieve* a high standard of business ethics in the securities industry." 406 U.S. at 151, 92 S.Ct. at 1471 (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186, 84 S.Ct. 275, 280, 11 L.Ed.2d 237 (1963)) (second emphasis added). And more recently, in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977), the Court noted that it "repeatedly has described *the 'fundamental purpose'* of the [1934 Act] as implementing a 'philosophy of full disclosure'; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute." *Id.* at 477–78, 97 S.Ct. at 1303 (emphasis added). Thus, the Supreme Court has repeatedly held that the *method* which Congress has chosen to promote a high standard of business ethics in the securities markets is to require full disclosure.

As enforced by private plaintiffs seeking money damages, Rule 10b–5 serves both deterrent and compensatory purposes. These compensatory purposes, however, are not without limits. Although Rule 10b–5 may be thought of as remedial legislation, which should be interpreted "not technically and restrictively, but flexibly to effectuate its remedial purposes," *Affiliated Ute*, 406 U.S. at 151, 92 S.Ct. at 1471, "we are not dealing here with any private right of action created by the express language of § 10(b) or of Rule 10b–5. . . . We are deal-

tion of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges. See S.Rep.No. 792, 73d Cong., 2d Sess., 1–5 (1934).

Id. at 195, 96 S.Ct. at 1382. Even more informative is the actual language from *Tcherepnin v. Knight*, 389 U.S. 332, 88 S.Ct. 548, 19 L.Ed.2d 564 (1967):

> The Securities Exchange Act [of 1934] quite clearly falls into the category of remedial legislation. One of its central purposes is to protect investors *through the requirement of full disclosure by issuers of securities*, and the definition of security in § 3(a)(10) necessarily determines the classes of investments and investors which will receive the Act's protections.

Id. at 336, 88 S.Ct. at 553 (emphasis added; footnote omitted). The majority also cites *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974), but that case says:

> As we have stated time and again, the purpose behind Section 10(b) and Rule 10b–5 is to protect the investing public and to secure fair dealing in the securities markets *by promoting full disclosure of inside information so that an informed judgment can be made by all investors who trade in such markets.*

Id. at 235 (emphasis added). And in *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970), we described Congress' intent as follows:

> In short, *Congress meant to afford investors a reasonable opportunity to make knowing, intelligent decisions regarding their purchases and sales of securities in unmanipulated markets,* . . and the loss resulting in connection with purchases or sales made without benefit of such an opportunity is the type of injury section 10(b) and Rule 10b–5 seek to prevent.

Id. at 806 (emphasis added).

18. *Ante*, 647 F.2d at 471.

ing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 748–49, 95 S.Ct. 1917, 1931, 44 L.Ed.2d 539 (1975) (emphasis added).

This court recognized over a decade ago that, in the context of a private suit for damages,

> the sweeping language of Rule 10b-5 creates an almost completely undefined liability. All that the rule requires for its violation is that someone "do something bad" in connection with a purchase or sale of securities. Without further delineation, civil liability is formless, and the area of proscribed activity would become so great that the beneficial aspects of the rule would not warrant the proscription. In recognition of this problem, courts have sought to construct workable limits to liability under section 10(b) and Rule 10b-5 which will accommodate the interests of investors, the business community, and the public generally.

Herpich v. Wallace, 430 F.2d 792, 804–05 (5th Cir. 1970) (citations omitted). In an accompanying footnote, *id.* at 805 n.22, we listed the reliance requirement first among the court-made limits on civil liability under Rule 10b-5. Citing our decision in *Herpich*, with approval, the *Blue Chip Stamps* Court shared our "concern that the inevitable broadening of the class of plaintiffs who may sue in this area of the law will ultimately result in more harm than good." 421 U.S. at 747–48, 95 S.Ct. at 1931.

The Supreme Court and this court have recognized that there must be limits in defining the class of persons who may recover under Rule 10b-5. The policy question presented by the case at bar is whether the traditional reliance requirement is a sensible limit in all cases in which the plaintiff has made an investment decision. I believe that the question must be answered in the affirmative.

The reliance requirement promotes the objectives of the 1934 Act by precluding recovery to a plaintiff who has made an investment decision by his own lights and without reference to the information promulgated under the disclosure requirements of the federal securities laws. Whether disclosure is viewed as a goal or as a means to achieve a goal, it is central to the way in which the federal securities laws function. Just as the threat of litigation and extensive liability under Rule 10b-5 is intended to deter fraudulent conduct connected with the purchase or sale of a security, the reliance requirement is intended to encourage investors to base their investment decisions on information required by the securities laws to be disclosed. In short, the federal securities laws are intended to put investors into a position from which they can help themselves by relying upon disclosures that others are obligated to make. This system is not furthered by allowing monetary recovery to those who refuse to look out for themselves. If we say that a plaintiff may recover in some circumstances even though he did not read and rely on the defendants' public disclosures, then no one need pay attention to those disclosures and the method employed by Congress to achieve the objective of the 1934 Act is defeated. Indeed, after reading the offering circular in this case and considering the disclosures about the weak and highly questionable financial position of ASECo that were made therein, I am left with the nagging question of whether Bishop would have had a loss if he had read the offering circular, latently defective as it may have been.[14]

14. The inadvisability of taking any action that would have the effect of minimizing or eliminating the need to read the offering circular is highlighted by the facts of this case. The offering circular may well have contained the latent material misrepresentations and omissions described at great length and in detail in the plaintiff's second amended complaint. But if the plaintiff or someone acting for the plaintiff (such as the broker from whom he bought the bonds, who is not a defendant in this case) had read the offering circular, the disclosures that are made in the financial statements included therein might very well have warned him of the risk inherent in the bonds and of the calibre of

Apart from the fact that the reliance requirement makes sense in the context of the objectives of the 1934 Act and the method chosen by Congress to achieve those objectives, there is another reason for not eliminating the reliance requirement in a suit under Rule 10b–5. To paraphrase Justice Stewart's opinion in *Aaron v. SEC*, 446 U.S. 680, 689, 100 S.Ct. 1945, 1951, 64 L.Ed.2d 611 (1980), we do not write on a blank slate in determining whether reliance is a necessary element for recovery under section 10(b) and Rule 10b–5. The basic requirements of a cause of action under Rule 10b–5 (which are listed in part III of the majority opinion) have remained largely intact since the Rule was adopted. The Supreme Court has consistently turned back efforts to eliminate or water down those requirements. *E. g.*, *Santa Fe Industries, Inc. v. Green*, *supra* (only conduct involving manipulation or deception is reached by section 10(b) or Rule 10b–5; private action under Rule 10b–5 will not lie for mere abuse of fiduciary duty); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976) (private cause of action for damages will not lie under section 10(b) and Rule 10b–5 in the absence of any allegation of scienter; allegation of negligence insufficient); *Blue Chip Stamps v. Manor Drug Stores*, *supra* (private damages action under Rule 10b–5 is confined to actual purchasers or sellers of securities).[17] *Cf. Aaron*

the people involved in the transaction pursuant to which the bonds were issued.

The second paragraph of the accountant's report on the financial statements of ASECo, Inc. as of August 31, 1972, reveals on its face that the accompanying financial statements were *not* prepared in accordance with generally accepted accounting principles:

> Investment real estate having a net book value of $473,436.66 is carried on the enclosed balance sheet at $2,420,500, an increase for statement purposes of $1,947,-063.34. One parcel is supported by an appraisal dated October 12, 1971, by a member of the American Institute of Real Estate Appraisers at a value of $2,284,000.

The significance of the increase in the carrying value of the real estate "for statement purposes" in the amount of $1,947,063.34 becomes clear when we turn to the balance sheet, where the net worth of ASECo, Inc. is shown as $2,203,657.33. If we subtract from that net worth the amount wrongly included in it ($1,947,063.34), we are left with a net worth of $256,593.99. If we examine that number more closely, we find that it is based in part on three items (totaling $430,787.05) included in Current Assets under the heading "Advances to Stockholders"—one item in the amount of $176,-091.40 called "Open Notes," a second item in the amount of $54,695.65 called "Used for purchase of corporate shares for company account," and a third item in the amount of $200,000.00 called "Capital Stock subscriptions receivable." The footnote to the "Open Notes" item contains the following piece of information: "Stockholders propose to liquidate a portion of these advances by assigning to the corporation their equity in residence real estate, valued at $77,000.00." The footnote to the "Used for purchase of corporate shares for company account" item contains this description of the transaction involved: "The stockholders obtained funds for the purpose of purchasing certain common stocks for the account of the company. We were advised that the shares have been forwarded to the registrars for registration in the company's name." Finally, the footnote to the "Capital Stock subscriptions receivable" item contains the following information: "The company is holding a note from J. C. Harrelson in which he has promised to purchase 1667 shares of capital stock in the company within sixty days of August 31, 1972."

All three of the items listed in current assets under the heading "Advances to Stockholders" would have to be viewed with *great* skepticism, particularly in view of their materiality, individually and in the aggregate, to the financial statements. And, if they are eliminated from current assets, ASECo, Inc. is insolvent.

In summary, the accountant's report included in the offering circular is irregular on its face; the financial statements included therein are highly questionable on their face and strongly suggest that ASECo, Inc. was insolvent or nearly so on the balance sheet date. The average investor in industrial revenue bonds, when presented with the accountant's report and financial statements for ASECo, Inc. would, in my view, have had a good indication that the entire transaction was questionable and extremely risky.

17. Indeed, of late the Court has shown marked reluctance to extend the contours of private causes of action under the securities laws generally. *E. g.*, *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979) (no implied private right of action under § 206 of Investment Advisers Act of 1940); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 99 S.Ct. 2479, 61 L.Ed.2d 82 (1979) (no implied private right of action under § 17(a) of 1934 Act); *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 97 S.Ct. 926, 51 L.Ed.2d 124

v. *SEC*, *supra* (SEC is required to establish scienter as an element of a civil enforcement action to enjoin violations of section 10(b) and Rule 10b-5); *Chiarella v. United States*, 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980) (recognizing that while silence in connection with purchase or sale of securities may operate as a fraud actionable under Rule 10b-5(1) and (3), criminal liability must be premised on duty to disclose arising from relationship of trust and confidence between parties to a transaction). We do not have a license to do what the Supreme court has refused to do.

B. *The Majority's "Fraud on a Broader Scale" Exception to the Reliance Requirement*

The majority opinion contains two conflicting views of the nature of this case. The opening lines of the majority opinion describe the plaintiff's complaint as alleging "in essence . . . that the defendants had fabricated a materially misleading Offering Circular in order to induce the Industrial Development Board . . . to issue, and the public to buy, fraudulently marketed bonds." [18] But elsewhere in the opinion, the offering circular is described as "only one component of the overall scheme." [19] Following the latter view of the case, the majority opinion states that "[w]henever the rule 10b-5 issue shifts from misrepresentation or omission in a document to fraud on a broader scale, the search for causation must shift also. The 'reliance' that produces causation in the latter type of case cannot come from reading a document. It may arise from . . . a claim by a bond buyer that he relied on the market to provide securities that were not fraudulently created. . . ." [20]

The conflicts in the majority opinion suggest the question: What kind of a case do we really have here?

The answer to that question is clear to me. The majority opinion had it right the first time. We have a case in which the fraud on the plaintiff and the other purchasers of the bonds was effected by means of a misleading offering circular. The defendants are the participants in that offering—the underwriters who sold the bonds, the lawyers who participated in the preparation of the offering circular, the accounting firm that rendered a report on the financial statements included in the offering circular, the bank that acted as a trustee under the mortgage securing the bonds, and various persons who are alleged to have aided and abetted the issuer of the bonds and controlling persons of the issuer. While the plaintiff's second amended complaint chronicles at length and in detail the manner in which the proceeds of the bonds were allegedly dissipated or diverted, the essence of the fraud insofar as the plaintiff and other bond purchasers are concerned consisted of the sale of bonds to the public by means of a misleading offering circular. The "shift" in the Rule 10b-5 issue described in the majority opinion to "fraud on a broader scale" is a shift effected by the majority in order to avoid the result otherwise mandated by the application to this case of the traditional elements of a private cause of action under Rule 10b-5. The majority's only justification for the shift is that Bishop's complaint, like all Rule 10b-5 complaints, tracks the language of the entire Rule and urges the applicability of clauses (1) and (3).[21]

(1977) (no implied private right of action under § 14(e) of 1934 Act; unsuccessful tender offeror lacked standing to sue for damages under Rule 10b-6); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976) (rejecting Seventh Circuit's expansive definition of materiality in private suits under Rule 14a-9 as encompassing "all facts which a reasonable investor *might* consider important"; misstatement or omission in proxy solicitation is material only if there is "substantial likelihood" that a reasonable shareholder *would* (not "might") consider the fact important in deciding how to vote).

18. *Ante*, 647 F.2d at 464.

19. *Ante*, 647 F.2d at 469.

20. *Ante*, 647 F.2d at 472.

21. It does not appear that Bishop argued any of the majority's theories—his entitlement to rely on the integrity of the market, the bonds' lack of entitlement to be marketed, or the fraud on a

The majority correctly makes the point that the Rule is not limited to a narrow right to recover for knowing fraudulent misrepresentations or omissions in disclosure documents. It goes on to say that the Rule (meaning, presumably, clauses (1) and (3) of the Rule) is "recognized" to provide the basis for a federal cause of action for "fraud on a broader scale" or "more elaborate, intentional schemes which deceive or defraud purchasers of securities."[22] That statement is wrong. No other court has applied clause (1) or (3) of the Rule on the basis of the scale or elaborateness of the scheme to defraud. As the very cases cited by the majority demonstrate, clauses (1) and (3) of the Rule have been applied instead to cases in which the fraud is not covered by clause (2) of the Rule—*i. e.*, to total omissions cases, such as *Ute*, or to cases, such as *Schlick*, in which the fraud is accomplished by means of what the defendants did (*e. g.*, manipulated the market) rather than by means of what they said.[23]

To permit the plaintiff in a case clearly covered by clause (2) of the Rule to fall back on the broad language of clause (1) (which reaches schemes to defraud) or clause (3) (which reaches acts that operate as a fraud), in combination with allegations of elaborate collateral conduct, in order to obviate the effect of the failure to comply with the reliance requirement under clause (2), makes the reliance requirement of clause (2) a dead letter in the one situation in which it most typically applies—the offering of a security, pursuant to an offering circular, to investors who are called upon to make routine investment decisions. The majority notes in footnote 5 of its opinion that to do away with the reliance requirement in a Rule 10b–5(2) case could establish a scheme of investors' insurance, which numerous courts have held was not the intent of section 10(b). Yet, given the scienter requirement, it is difficult to conceive of conduct actionable under clause (2) of Rule 10b–5 that is not also actionable under the broader language of clauses (1) and (3). The majority's holding threatens to turn all of Rule 10b–5 into a scheme of investor's insurance—at least where the security offered can be shown to be not "entitled to be marketed"—and it does so in what is, insofar as the plaintiff is concerned, an ordinary transaction flowing from his voluntary investment decision to purchase a security.

In my view, clauses (1) and (3) of the Rule were drafted broadly so as to reach fraudulent behavior by defendants that is not covered by the literal language of clause (2). But clauses (1) and (3) should not be used, as they are by the majority, to obviate for a plaintiff any of the traditional proof requirements of a cause of action under clause (2).

The majority opinion is a harbinger of difficulties for future securities litigation. Surely ingenious plaintiffs' counsel will hereafter plead the "entitled to be marketed/fraud on a broader scale" theory at least as an alternative basis for recovery. The question whether a security was "entitled to be marketed," *i. e.*, whether the

broader scale—in the district court. These theories are not mentioned at all in the district court's memorandum opinion.

22. *Ante*, 647 F.2d at 472.

23. One leading commentary on the securities laws suggests that a distinction should be drawn between those situations in which the defendants themselves did something to the plaintiff and those situations in which the defendants induced the plaintiff to do something by means of a misrepresentation or omission of a material fact:

> Where the gravamen of the action is something other than misrepresentation or nondisclosure, then of course the question of reliance does not arise. For example, if the complaint is that the defendant sold $5,000,000 of securities belonging to the corporation and pocketed the proceeds, or used them to pay for a controlling block of the corporation's stock, as in [*Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971)], it makes no sense to ask whether anyone relied upon anything. *The complaint is about what the defendant did, not what he said or didn't say.*

R. Jennings & H. Marsh, Securities Regulation: Cases and Materials 1064 (4th ed. 1977) (emphasis added). This distinction is in accord with my discussion of the *Schlick* case in part II-C above.

security, absent the fraud, could have been sold at some price, and the question whether the scale of the fraud was broad enough, are both presumably questions of fact, not readily disposed of by summary judgment. The creation of this new recovery theory will not only breed more litigation, but it will also make that litigation more difficult and time consuming. Whether the end result will be any different can be determined only by seers.

The length to which the majority goes to preserve a remedy in federal court for Bishop suggests that Bishop and others like him who did not rely on the offering circular might otherwise be without a remedy. In fact, if what he alleges in his complaint is true, Bishop had a remedy under Rule 10b–5 against his broker, upon whom he did rely and who advised him that the bonds were a good investment. He chose, for reasons known only to him, not to sue his broker. Surely his election not to sue the person against whom he had a legitimate Rule 10b–5 claim and instead to sue those against whom recovery under Rule 10b–5 has heretofore been precluded should not result in this court's fashioning new law for his benefit. Further, the scheme to defraud that Bishop describes clearly constitutes common law conversion and would be actionable in state court. There is, therefore, no necessity in this case to create a new route to recovery under Rule 10b–5 in order to provide a remedy in federal court for Bishop and others like him who, by their own actions, have forfeited the protection of the Rule.

For the foregoing reasons, I would affirm the decision of the district court granting summary judgment in favor of the defendants.

Exhibit_E

Johanna W. NELSON, Individually and as representative of a class; Stephen J. Bild, Jr., Esther de la Parra, Louis G. Hermann, and Mary L. Steinmetz, Individually, and as representatives of the intervenor noteholder class, Plaintiffs,

v.

QUIMBY ISLAND RECLAMATION DISTRICT FACILITIES CORPORATION et al., Defendants, and related cross-actions and third-party actions.

No. C-77-0784 SC.

United States District Court,
N. D. California.

Jan. 23, 1980.

Securities fraud class action was brought by purchasers of bonds and notes. On pretrial motions, the District Court, Conti, J., held that: (1) triable issues of material fact existed as to whether trustee of express trust created by bond indenture was subject to liability in action with respect to issuance of bonds; (2) material issues of fact existed as to whether trustee was subject to liability with respect to issuance of notes; (3) bond/note certificates and accompanying documents did not constitute a "prospectus" so as to make municipal bond house subject to liability under Securities Act of 1933; (4) material issues of fact existed with respect to trustee's third-party complaint against individuals involved with entity which acquired and subsequently retired bond anticipation note; (5) material issues of fact existed as to complaint filed against individual members of investor group and who participated in allegedly fraudulent scheme to sell property; (6) material issues existed with respect to trustee's action against broker/dealer who was allegedly a member of syndicate which underwrote subject bonds; (7) third-party action filed by attorney who issued bond/note opinion letters against individuals who allegedly participated in sale of property was not subject to dismissal; (8) individuals' motion to vacate order allowing trustee to file third-party complaint would be denied; and (9) register of broker/dealer who served as underwriter of both bonds and notes would be allowed to file third-party complaint.

Ordered accordingly.

1. Federal Civil Procedure ⟹2511

In securities fraud class action brought by purchasers of bonds and notes, material factual issues existed with respect to issuance of certificate of authentication by bond indenture trustee, which stated that bonds were issued pursuant to and under provisions of certain indenture, precluding summary judgment on claim against trustee. Securities Act of 1933, § 17(a), 15 U.S.C.A. § 77q(a); Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

2. Securities Regulation ⟹147

Whether one performs one of the specified functions of an underwriter with respect to issuance of bond is a question of fact to be determined at trial. Securities Act of 1933, § 2(11), 15 U.S.C.A. § 77b(11).

3. Federal Civil Procedure ⟹2511

In securities fraud class action brought by purchasers of bonds and notes, material issues of fact existed as to whether bond indenture trustee became participant in allegedly fraudulent scheme or assisted in its completion with respect to alleged illegality surrounding bond/note transactions, precluding summary judgment.

4. Federal Civil Procedure ⟹2511

In securities fraud class action brought by purchasers of bonds and notes, material issues of fact existed with respect to noteholders' claims against bond indenture trustee because of alleged issuance of false certificate of authentication, precluding summary judgment. Securities Act of 1933, § 17(a), 15 U.S.C.A. § 77q(a); Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

5. Securities Regulation ⟹103

Civil liability may attach to the issuance of a false or misleading prospectus.

Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

6. Securities Regulation 🔑25

Bond and note certificates, which contained opinion of counsel and trustee's certificate of authentication, did not constitute a "prospectus" under Securities Act of 1933. Securities Act of 1933, § 2(10), 15 U.S.C.A. § 77b(10).

See publication Words and Phrases for other judicial constructions and definitions.

7. Securities Regulation 🔑135

Third-party complaint in securities fraud class action was not subject to dismissal on grounds of lack of in personam jurisdiction where jurisdiction of case was founded on Securities Exchange Act which permits service throughout United States and defendant had "minimum contacts" with United States. Securities Exchange Act of 1934, § 27, 15 U.S.C.A. § 78aa; Securities Act of 1933, § 22, 15 U.S.C.A. § 77v.

8. Indemnity 🔑15(4)

Indemnification is improper where party is found to have violated manipulative and deceptive practices provision of federal securities law or rule promulgated thereunder. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

9. Securities Regulation 🔑103

A party may violate provision of federal securities law governing civil liabilities in connection with prospectus or communications even if he is merely negligent. Securities Act of 1933, § 12(2), 15 U.S.C.A. § 77*l*(2).

10. Indemnity 🔑13.1(1)

Generally, indemnity becomes a consideration when one person is exposed to liability because of what another person did.

11. Indemnity 🔑13

Right to noncontractual implied indemnity rests upon equitable considerations.

12. Indemnity 🔑13

Two critical prerequisites are generally necessary for invocation of noncontractual implied indemnity in California: (1) damages which claimant seeks to shift are imposed upon him as result of some legal obligation to injured party, and (2) it must appear that claimant did not actively nor affirmatively participate in wrong.

13. Contribution 🔑5(6)

Contribution is generally available in federal securities fraud cases.

14. Federal Civil Procedure 🔑288

A claim for contribution may be asserted in a third-party action. Fed.Rules Civ. Proc. Rule 14(a), 28 U.S.C.A.

15. Contribution 🔑5(6)

A party is permitted to receive contribution, even if found to have violated certain provisions of federal securities law. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); Securities Act of 1933, §§ 12(2), 17(a), 15 U.S.C.A. §§ 77*l*(2), 77q(a).

16. Contribution 🔑5(6)

A statutory right to contribution is granted to those charged with violating California securities law as well as person seeking contribution was not wilful violator seeking contribution from person who was negligent. West's Ann.Cal.Corp.Code, §§ 25401, 25501, 25505.

17. Federal Civil Procedure 🔑283

Court is granted broad discretion in determining whether to allow third-party complaint.

18. Federal Civil Procedure 🔑291

In securities fraud class action brought by purchasers of bonds and notes, officer of professional law corporation which issued opinion on bonds and notes in question was entitled to maintain third-party action against members of investor group who participated in allegedly fraudulent scheme to sell property through issuance of securities that were subject of lawsuit.

19. Federal Civil Procedure 🔑948

If a party cannot reasonably be required to frame an answer because complaint is too vague or ambiguous, he may move for more definite statement before

answering. Fed.Rules Civ.Proc. Rule 12(e), 28 U.S.C.A.

20. Federal Civil Procedure ⇐672

A pleading must contain a short and plain statement of a claim showing that pleader is entitled to relief. Fed.Rules Civ. Proc. Rule 8(a)(2), 28 U.S.C.A.

21. Federal Civil Procedure ⇐958

If a pleading contains a short and plain statement of claim showing that pleader is entitled to relief and fairly notifies opposing party of nature of claim, motion for more definite statement will not be granted. Fed.Rules Civ.Proc. Rules 8(a)(2), 12(e), 28 U.S.C.A.

22. Federal Civil Procedure ⇐1018

In securities fraud class action brought by purchasers of bonds and notes, third-party defendants who were members of investor group who participated in allegedly fraudulent scheme to sell property through issuance of securities subject of lawsuit were not entitled to more definite statement with respect to complaint filed by officer of professional law corporation which issued opinion on bonds and notes. Fed.Rules Civ.Proc. Rules 8(a)(2), 12(e), 28 U.S.C.A.

23. Federal Civil Procedure ⇐2511

In securities fraud class action brought by purchasers of bonds and notes, material issues of fact existed with respect to third-party complaint filed by bond indenture trustee against broker/dealer, who allegedly was member of syndicate which underwrote subject bonds, precluding summary judgment.

24. Federal Civil Procedure ⇐295

Within meaning of rule stating that party impleading need not obtain leave to make service if he files third-party complaint not later than ten days after he serves original answer, term "original answer" refers to first answer to complaint that is in effect at that time, as opposed to any amended or supplemental answer to that complaint. Fed.Rules Civ.Proc. Rule 14, 28 U.S.C.A.

See publication Words and Phrases for other judicial constructions and definitions.

25. Federal Civil Procedure ⇐294

In securities fraud class action brought by purchasers of bonds and notes, third-party action filed by attorney who issued bond/note opinion letters against individuals who allegedly participated in sale of property through issuance of bonds in question was allowed to stand despite contentions that complaint was filed improperly and was unduly prejudicial. Fed.Rules Civ. Proc. Rule 14, 28 U.S.C.A.

26. Federal Civil Procedure ⇐294

In securities fraud class action brought by purchasers of bonds and notes, third-party complaint filed by attorney who issued bond/note opinion letters against individuals who sold certain property through issuance of securities in question was not so vague or ambiguous so as to require more definite statement.

27. Federal Civil Procedure ⇐1809

In securities fraud class action brought by purchasers of bonds and notes, third-party complaint filed by bond indenture trustee against individuals who sold certain property through issuance of securities in question was not subject to dismissal.

28. Federal Civil Procedure ⇐971

In securities fraud class action brought by purchasers of bonds and notes, third-party complaint filed by bond indenture trustee against individuals who sold certain property through issuance of securities in question was not so vague or ambiguous as to make it unreasonable to require proper answer and be subject to motion for more definite statement.

29. Federal Civil Procedure ⇐292

In securities fraud class action brought by purchasers of bonds and notes, registered broker/dealer who served as underwriter of both bonds and notes was entitled to file third-party complaint despite contention of unfair delay in bringing third-party action.

R. Alan Stotsenburg, Stotsenburg & Donohue, P. C., New York City, Robert J. Heil, Ferguson, Hoffman, Henn, Mandel & Heil, Inc., San Francisco, Cal., Black & Deitrick, Walnut Creek, Cal., Toll & Leavitt, Los

Angeles, Cal., for plaintiff Johanna W. Nelsen and the bondholder class. .

Terrance L. Stinnett, Goldberg, Stinnett & MacDonald, San Francisco, Cal., James J. Farley, Scottsdale, Ariz., for intervenors-plaintiffs Bild, de la Parra, Hermann & Steinmetz.

Max H. Mortensen, John B. Schoenfeld, DDS, Robert D. Lewis, DDS and Lowell C. Lundell, DDS, in pro. per.

Theodore W. Phillips, Phillips, Cohn & Greenberg, San Francisco, Cal., for defendant Urban J. Schreiner.

Charles S. Kenady, Jr., E. Garth Black, Cooper, White & Cooper, San Francisco, Cal., for defendant Harold E. Rogers.

Bruce D. Wagner, Michael J. Brady, Ropers, Majeski, Kohn, Bentley & Wagner, Redwood City, Cal., for defendants Nichols, Rogers & Schreiner, P. C. and Rogers & Schreiner.

Richard B. Schreiber, Thomas G. Wood, Severson, Werson, Berke & Melchior, San Francisco, Cal., for defendant Union Bank.

Daniel A. Weber, Mitchell, Silberberg & Knupp, Los Angeles, Cal., for defendants Municicorp of California, Inc., Kenneth W. Rogers & Alan M. Stahl.

James Goldman, Kadison, Pfaelzer, Woodward, Quinn & Rossi, Los Angeles, Cal., for defendants Gibralco, Inc. & Charles L. Gunther.

Richard C. Brautigam, Philip R. Rotner, McCutchen, Doyle, Brown & Enersen, San Francisco, Cal., for defendant Alan H. Nichols.

Jock Patton, Streich, Lang, Weeks & Cardon, Phoenix, Ariz., Bronson, Bronson & McKinnon, San Francisco, Cal., for third-party defendants Oxford Life Insurance Company and Theodore D. Wilkins.

Cambridge Insurance Services Corp. and Jack D. Milligan, in pro. per.

Peter Taft, Munger, Tolles & Rickerhauser, Los Angeles, Cal., for third-party defendants Marshall Cornblum, Raymond Bolton, Thiel, Bolton & Cornblum.

Ronald D. Packard, Packard & Packard, Palo Alto, Cal., for third-party defendants Packards & Prahm.

Richard Marx, Blumenfeld, Marx, Tureen & Paster, P. C., Clayton, Mo., Richard M. Kaplan, Kaplan, Levy, Samrick & Bernard, San Francisco, Cal., for third-party defendant Stix & Co.

John Charron, Charron & Whitaker, St. Louis, Mo., John Vasil, Petris Vasil & Bradley, Campbell, Cal., for third-party defendant Harry F. Mayfield.

Robert D. Carrow, Carrow, Forrest & Jordan, Novato, Cal., for third-party defendant Harvey Sullivan.

M. Laurence Popofsky, Charles N. Freiberg, Heller, Ehrman, White & McAuliffe, San Francisco, Cal., for third-party defendant Jeffrey Crews.

Charles A. Wood, Jr., Tinning & DeLap, Walnut Creek, Cal., for third-party defendant Martin V. Lyle.

Marvin Smith, Santa Rosa, Cal., in pro. per.

Robert Reeser, Oakland, Cal., for third-party defendants Aquatic Innovations, Inc., L. Mortensen and Chris Mortensen.

Patrick E. Catalano, James A. DuCharme, Law Offices of Patrick E. Catalano, San Francisco, Cal., Donald R. Wild, Wilson, Elser, Edelman & Dicker, San Francisco, Cal., for third-party defendants Frank Lee Crist, Jr., Crist, Crist, Griffiths, Bryant, Schulz and Biorn, P. C.

ORDER

CONTI, District Judge.

This is a securities fraud class action brought by the purchasers of bonds and notes issued by the Quimby Island Reclamation District Facilities Corporation (hereinafter Facilities Corporation). This case is before the court on eleven separate motions, which will be examined in turn.

I. *DEFENDANT UNION BANK'S MOTION FOR SUMMARY JUDGMENT AGAINST PLAINTIFFS.*

A. *SUMMARY JUDGMENT*

The parties and the court are well aware that before a summary judgment may be

granted under F.R.Civ.P. 56, the pleadings, depositions, answers to interrogatories, admissions on file, and the accompanying affidavits must "show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." F.R.Civ.P. 56(c); *MGM Grand Hotel, Inc. v. Imperial Glass Co.*, 533 F.2d 486, 488 (9th Cir.), *cert. denied*, 429 U.S. 887, 97 S.Ct. 239, 50 L.Ed.2d 168 (1976) (quoting *Radobenko v. Automated Equip. Corp.*, 520 F.2d 540, 543 (9th Cir. 1975)).

The party moving for summary judgment has the burden of clearly establishing the lack of any triable issue of material fact. It is not the function of the trial court at the summary judgment hearing to resolve any genuine factual issue, including credibility; and for purposes of ruling on the motion, all factual inferences are to be taken against the moving party and in favor of the opposing party. Discretion plays no real role in the granting of summary judgment. *See* 6 *Moore's Federal Practice* ¶ 56.15[8], at 56-642-643.

B. *BACKGROUND*

Defendant Union Bank is a party because it entered the bond indenture and thereby became a trustee on the express trusts created by the indenture.[1] As a trustee, it executed a certificate of authentication (hereinafter certificate) which stated:

> This bond is one of the bonds issued pursuant to and under the provisions of the within mentioned Indenture.
>
> Union Bank as trustee
>
> By ____________________
>
> Authorized Officer

Under Section 204 of the bond indenture, a bond was invalid unless it was endorsed with the certificate issued by the trustee. Before a bond could be authenticated, however several papers had to be delivered to the trustee,[2] including:

> 1. A copy of the resolution adopted by the Board of Directors of the Facilities

1. Union Bank also agreed to act as indenture trustee for the note issuance while it was serving as trustee for the bonds.

2. Section 207 of the bond indenture provided:
Filing of Closing Documents and Delivery of Bonds. Said Bonds, upon their execution in the form and manner set forth in Exhibits A, B, and C hereto, and as herein provided, shall be deposited with the Trustee for authentication, but before said Bonds shall be authenticated and delivered by the Trustee there shall be filed with or delivered to the Trustee the following:
(a) A copy of the resolution adopted by the Board of Directors of the Corporation and certified by its Secretary authorizing the issuance of the Bonds and directing the authentication and delivery of such Bonds to or upon the order of the purchasers therein named upon payment of the purchase price therein set forth;
(b) Bond counsel's opinion to the effect that:
(i) This indenture has been duly and lawfully authorized, executed, and delivered by the Corporation, is in full force and effect, and is valid and binding upon the Corporation in accordance with its terms, and that such Bonds are valid, binding and direct obligations of the Corporation, in accordance with their terms and the terms of this Indenture, and such Bonds have been duly and validly authorized and issued in accordance with law and this Indenture; and
(ii) the Bonds are not subject to any federal stamp tax in respect of either the issuance thereof or the subsequent transfer thereof or that any such tax on the issuance of said Bonds has been paid; and
(iii) the Bonds, under the circumstnaces of the issuance and sale thereof, are not required to be registered under the Securities Act of 1933, as amended, and qualification of this Indenture under the Trust Indenture Act of 1939 is not required; and
(iv) that any permit or permits of the Commissioner of Corporations of the State of California necessary under the California Corporate Securities Law to the sale and issuance of the Bonds has been obtained, and stating the basis of such opinion or opinions; and
(c) The purchase price of the Bonds being paid on delivery.
Such Bonds may be authenticated, delivered, and paid for in amounts of less than the total authorized principal amount, from time to time, as the Corporation may direct upon its written order to the Trustee.
When the documents mentioned above shall have been filed with the Trustee and when said Bonds shall have been executed with authenticated [sic] as required by this Indenture, the Trustee shall be entitled to rely upon such resolution as to the names of the purchasers and the amounts of such purchase price.

Corporation,[3] certified by its Secretary, authorizing the issuance of the bonds and directing the authentication and delivery of such bonds to the named purchasers upon payment of the purchase price; and 2. Bond counsel's opinion to the effect that the indenture had been duly and lawfully authorized, executed, and delivered by the Facilities Corporation, that it was in full force and effect, and that it was valid and binding upon the Facilities Corporation in accordance with its terms, and that the bonds were valid, binding, and direct obligations of the Facilities Corporation, in accordance with their terms and the terms of the indenture, and that the bonds had been duly and validly authorized and issued in accordance with law and the indenture.

Section 207. The purchase price also had to be paid upon delivery. Finally, the bond indenture provided that the bonds could "be authenticated, delivered, and paid for in amounts of less than the total authorized principal amount, from time to time, as the [Facilities Corporation]" directed upon written order to the trustee. The agreement thus provided for multiple transactions.

Union Bank's liability as trustee under the indenture was limited. Section 902 provided, in pertinent part, that:

> [t]he Trustee shall not have any responsibility in respect of the validity or sufficiency of this Indenture or the due execution or acknowledgment thereof by the Corporation, or in respect of the validity of any Bonds authenticated and delivered by the Trustee in accordance with the provisions of this Indenture, or of the coupons appertaining thereto. The recitals, statements and representations contained herein [the Indenture] and in the Bonds (*excluding the Trustee's certificate on the Bonds*) shall be taken and construed as made by and on the part of the Corporation and not by the Trustee and the Trustee does not assume nor shall it be under any responsibility for the correctness of the same. (Emphasis added.)

The trustee was liable under Section 906, however, for its own negligent actions, or its negligent failure to act, as well as its own wilfull misconduct.

Plaintiffs' primary allegation is that the Union Bank, in its position as trustee, participated with other defendants in a fraudulent scheme or course of conduct to sell worthless bonds and notes to the investing public. In addition, plaintiffs maintain that Union Bank served as a statutory underwriter in the bond and note issuances. Finally, plaintiffs contend that Union Bank failed to comply with certain provisions of the trust indenture and thereby issued a certificate which was false. By conducting its operations in this way, defendant is alleged to have violated various state and federal securities laws. Those statutes which are relevant to this motion will be explicitly set forth in subsequent pages of this order.

C. *UNION BANK'S MOTION*

Union Bank moves for summary judgment on the following grounds:

(1) Union Bank made no misrepresentations in the trustee's certificate which appeared on the bonds and notes;

(2) The fact that the bonds were "authenticated, delivered, and paid for" over a period of time, rather than in a single transaction, does not render Union Bank a "statutory underwriter" within the meaning of the Securities Act of 1933, § 2(11), 15 U.S.C. § 77b(11);

3. The bondholders contend, and will ask the jury to find, that the creation of the Facilities Corporation was itself a fraudulent device to evade the restrictions of the California Water Code on the issuance of bonds. In particular, a nonprofit corporation was formed to issue the bonds at an interest rate higher than the maximum permitted by the Water Code, 7 percent, while purportedly maintaining the entitlement of any bonds issued by Facilities Corporation to tax-exempt status on the basis that they were issued "on behalf of" the District as permitted by the Internal Revenue in appropriate cases.

Plaintiffs' Memorandum in Support of Cross Motion for Summary Judgment at 38. *Nelson v. Quimby Island*, No. C-77-0784-SC (N.D.Cal. 1979).

(3) Plaintiffs' miscellaneous allegations regarding the so-called "scheme" (a) attempt to impose duties upon Union Bank that it never assumed, (b) do not state a claim for securities fraud, and (c) attempt to re-inject into this litigation issues and claims that the court has previously eliminated from the case.

1. *Certificate of Authentication*

Plaintiffs' assertion that defendant Union Bank issued a false certificate is based on the following allegations:

(1) The Board of Directors of the Facilities Corporation never adopted a resolution authorizing the issuance of any bonds and directing the authentication and delivery of such bonds so that defendant trustee did not have a copy of any resolution when it issued the certificate;

(2) Union Bank failed to obtain the purchase price for the bonds;

(3) Union Bank never received a "written order" from the Facilities Corporation before entering into twenty-five partial bond closings;

(4) Union Bank did not deliver the bonds to purchasers named in the Facilities Corporation resolution; and

(5) Union Bank lacked a legal opinion of bond counsel when it authenticated the bonds.[4]

In light of the above, plaintiffs maintain that when defendant trustee signed the certificate saying that the bonds and notes were issued "pursuant to and under the provisions" of the indenture, it allegedly misrepresented the facts and thereby breached its fiduciary duties to the bondholder/noteholders and violated Securities Act of 1933, § 17(a), 15 U.S.C. § 77q(a),[5] Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b),[6] and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979).[7] Plaintiffs' Memorandum in Support of Cross Motions for Summary Judgment at 12.

Defendant Union Bank vehemently disagrees with these allegations. It maintains that the certificate was true since the instruments were genuine and the certificate's only significance was to certify that the instruments were "not spurious, counterfeit, or false." *Ainsa v. Mercantile Trust*

4. *See* note 1 *supra*.

5. This section provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of circumstance under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

6. This is the basic antifraud section of the 1934 Act which prohibits the use or employment of any manipulative or deceptive devices in the purchase or sale of a security registered on a national securities exchange. 69 Am.Jur.2d *Securities Regulation—Federal* § 185 (1973).

7. Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud;

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The derivation of Rule 10b-5 is peculiar. Although the authority for the Rule comes from § 10(b) of the Securities Exchange Act of 1934, the draftsmen turned their backs on the language of that section and borrowed the words of § 17 of the Securities Act of 1933, simply broadening these to include frauds on the seller as well as on the buyer. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976, 89 S.Ct. 1454, 22 L.Ed.2d 756 (1969), 404 U.S. 1005, 92 S.Ct. 561, 30 L.Ed.2d 558 (1971).

Co., 174 Cal. 504, 512, 163 P. 898 (1917). Union Bank asserts that, in any event, all of the procedures were properly followed so that there is no liability.

[1] Aware of the strict standard which must be followed in summary judgment cases, the court does not believe that the record is adequate to resolve all material factual issues surrounding the issuance of the certificate, and thus it would be inappropriate to grant Union Bank's summary judgment motion on that point. There is insufficient evidence to determine whether or not Union Bank followed the necessary procedures before issuing the certificate.[8] Moreover, neither side has convinced the court of what significance the securities field attaches to a certificate such as the one present here. And in any event, the court believes that Union Bank's state of mind, that is scienter, is at least one issue to be tried by a jury.

2. *Union Bank as a Statutory Underwriter*

As noted earlier, plaintiffs contend that defendant Union Bank conducted itself in such a manner that it became an underwriter as defined in the Securities Act of 1933, § 2(11), 15 U.S.C. § 77b(11). Under that section, the term "underwriter"

> means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in the direct or indirect underwriting of any such undertaking . . . .
>
> The term "underwriter" is defined not with reference to the particular person's general business but on the basis of his relationship to a particular offering. No distinction is made between professional investment bankers and rank amateurs. Any person who performs one of the specified functions in relation to the offering is a statutory underwriter even though he is not a broker or a dealer.

1. L. Loss, *Securities Regulation* 547 (2d ed. 1961).

Plaintiffs cite deposition testimony of Union Bank's Executive Vice President, Janet Crawford, (Evidentiary Appendix, Exhibit F, at 391) to the effect that Union Bank distributed bonds without the required authority from the issuer, the Facilities Corporation. Moreover, it allegedly allowed bonds to be sold at discounts without obtaining prior permission. Plaintiffs conclude that Union Bank's "conduct was in this respect no different from that of a broker-dealer acting as an underwriter who also customarily sets the price at which it will market securities which it has purchased from an issuer." As an underwriter, Union Bank allegedly failed to make at least some investigation of the facts underlying the securities issuance and is therefore liable to the purchasers who suffered harm. *See Sanders v. John Nuveen & Co.*, 524 F.2d 1064, 1071 (7th Cir. 1975), *vacated on other grounds*, 425 U.S. 929, 96 S.Ct. 1659, 48 L.Ed.2d 172 (1976); 554 F.2d 790 (7th Cir. 1977).

Defendant Union Bank counters with affidavits saying that it never sold bonds or notes to anyone, but in fact merely transferred them to those engaged in the underwriting and public distribution in return for payments credited to the account of the issuer.[9]

8. Although it appears that there might have been certain irregularities in the procedures followed prior to the certificate's issuance, the conflicting record does not permit the court to determine if these are "hypertechnical" or not. For example, it is not clear what authority Mr. Mortensen possessed as general manager of both the Facilities Corporation and the Quimby Island Reclamation District, and thus the court cannot make a finding as to whether or not Union Bank received proper "written orders" before entering into the partial closings. This matter, as well as the other four, needs to be developed more fully at trial.

9. Union Bank asserts that it did not become a statutory underwriter simply because it issued instruments at several partial closings. Whether the bonds/notes were issued at one transaction or many is not the essential point, since the indenture appears to permit multiple transactions. The primary issue is thus whether Union Bank conducted itself within the definition of § 2(11), and that is a factual determination that the court cannot make based on a

[2] Whether one performs one of the specified functions of an underwriter is a question of fact to be determined at trial. The court, in accord with the strictures of Rule 56, chooses not to make any factual determinations based upon the limited record presented by the parties. For that reason, Union Bank's motion for summary judgment regarding the statutory underwriter issue is denied.

3. *Union Bank's Participation in a Scheme*

On February 7, 1974, Facilities Corporation passed a resolution appointing Union Bank as trustee on behalf of the bondholders. The District later approved of this appointment. As noted, plaintiffs intend to present evidence at trial that Union Bank was a knowing participant in a fraudulent scheme to sell worthless bonds and notes, or at least, it was an aider and abettor of such a plan.

The alleged scheme is outlined in plaintiffs' consolidated amended complaint. In sum, plaintiffs allege that Union Bank: (1) participated in the March 15, 1974 partial closing which violated federal and state securities laws; (2) knew of the illegal self-dealing in the purchase and sale of Quimby Island; (3) knew that bond counsel's opinion contained materially false representations; (4) knew that the Internal Revenue Service ruling that the bonds were tax exempt was obtained by deceit;[10] and (5) knew that false statements were printed on the face of the bonds.

Defendant counters by saying that plaintiff is attempting to impose duties upon defendant that the latter never assumed or that the indenture did not contain. Union Bank also asserts that plaintiffs are trying to reinject claims into the present lawsuit which have been dismissed to the state court.

brief excerpt from a lengthy deposition and conflicting affidavits and exhibits. For example, before the court can determine that Union Bank did or did not deliver bonds without authority from the Facilities Corporation, the authority possessed by Mr. Mortensen must be ascertained. *See* note 8 *supra*. The mere fact that an indenture trustee performed its duties as enumerated in the indenture agreement does not convert it into an underwriter.

In its order of February 3, 1978, this court stated:

> [B]efore someone can be caught within the net of aiding and abetting liability under Rule 10b–5, another party must have violated the securities laws, the alleged aider-abettor must be generally aware of his role in improper activity, and he must knowingly render substantial assistance.

Woodward v. Metro Bank of Dallas, 522 F.2d 84, 97 (5th Cir. 1975).

The Ninth Circuit has elaborated on the aiding/abetting issue and found that:

> [a]n aider and abettor may be liable for damages even though his assistance of the scheme consists of mere silence or inaction . . . That liability arises, however, only when a duty to disclose has arisen . . . The duty to disclose may arise upon the possession of " 'inside information' " . . . or upon " 'knowing assistance of or participation in a fraudulent scheme' " . . . or upon a consent and approval of fraudulent practices by a director.

Strong v. France, 474 F.2d 747, 752 (9th Cir. 1973) (citations omitted).

[3] As noted earlier,[11] Union Bank's liability as indenture trustee was limited. Whether Union Bank became a participant in the allegedly fraudulent scheme or assisted in its completion, and thereby assumed a greater duty and correspondingly greater liability, are questions not suitable for summary judgment. It is not clear if, or to what extent, Union Bank participated in the alleged illegalities surrounding the bond/note transactions, nor is it clear to what extent Union Bank knew about the

10. The court paid little attention to this claim since plaintiffs have failed to allege by what means defendant Union Bank obtained this knowledge.

11. *See* section (I)(B) *supra*.

alleged improprieties. These are factual determinations, and the length of the parties' moving papers and their frequent citation to deposition testimony and indenture provisions betray their assertions that there are undisputed facts upon which the court can make a legal conclusion. In accord with Rule 56, the court concludes that Union Bank's motion for summary judgment regarding its alleged participation in a fraudulent bond/note scheme is denied.[12]

Since Union Bank's motion for summary judgment is denied, the court chooses not to dismiss the state claims for lack of jurisdiction. *See United Mineworkers of America v. Gibbs*, 383 U.S. 715, 726–27, 86 S.Ct. 1130, 1139–1140, 16 L.Ed.2d 218 (1966).

II. *PLAINTIFF BONDHOLDERS' MOTION FOR SUMMARY JUDGMENT AGAINST DEFENDANT UNION BANK.*

Plaintiffs' motion is practically the mirror image of Union Bank's motion. For the reasons enumerated in Section I, the court denies plaintiffs' motion for summary judgment.

III. *PLAINTIFF NOTEHOLDERS' MOTION FOR SUMMARY JUDGMENT AGAINST DEFENDANT UNION BANK.*

On July 14, 1974, Union Bank executed the Supplemental Indenture of Mortgage and Deed of Trust, and thereby became the indenture trustee for the Quimby Island Reclamation District Facilities Corporation Bond and Revenue Anticipation Notes (hereinafter notes) issuance. The notes were issued, authenticated, and delivered in two series, the first on July 16, 1974, and the second on July 25, 1974.

Plaintiff noteholders maintain that the notes were issued under emergency conditions: there remained less than $40,000 in the construction fund[13] for the completion of the Quimby Island project, and the underwriters could no longer sell their bonds because of the rising interest rate. *Plaintiff Noteholders' Memorandum in Support of the Motion for Summary Judgment* at 11–12, 26–27. In order to provide additional funds for the purposes for which the bonds were issued, the corporation decided to issue short term, negotiable notes. A principal amount of $950,000 in two series was issued ($475,000 each), and Union Bank is alleged to have manually signed 190 instruments containing the trustee's certificate of authentication.

The noteholders' claim for summary judgment is strikingly similar to that of the bondholders. In sum, they allege that: (1) Union Bank issued a false certificate of authentication and thereby violated Securities Act § 17(a), Securities Exchange Act § 10(b), and Rule 10b–5; (2) Union Bank participated or aided and abetted a fraudulent scheme; and (3) Union Bank was a statutory underwriter.

12. One point deserving brief mention is that the court does not agree with Union Bank's assertion that plaintiffs are attempting to reinject state law claims into the present lawsuit. In their consolidated amended complaint, plaintiffs allege that Union Bank, by participating in the fraudulent scheme and issuing a false certificate of authentication, violated § 17(a), § 10(b), and Rule 10b–5. That is, it is claimed, among other things, to have employed a scheme to defraud and to have made untrue statements of a material nature. The fact that Union Bank is also charged with violating California law by committing the above acts is inconsequential since one act may violate both federal and state law. Defendant Union Bank's reference to *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977) lacks merit since in that case there was a failure to allege a material misrepresentation or material failure to disclose, conditions required by Rule 10b–5. *Id.* at 474, 97 S.Ct. at 1301. There was likewise no finding that a violation of § 10(b) or Rule 10b–5 occurred. *Id.*

13. According to the developer's plan, the district was to acquire Quimby Island and improve it for recreational use by the general public. A public sewage collection, treatment, and disposal system was to be built; a public water production, treatment, and distribution system was to be added; a facility for the local generation of electricity was to be built; and public transportation easements for pedestrian and non-automotive traffic were to be constructed. *See* Declaration of Robert E. Fairfax in Support of Union Bank's Motion for Summary Judgment, Exhibit D.

The difference in the two moving papers lies in the grounds upon which the parties base their first allegation. The noteholders contend that Union Bank issued a false certificate of authentication because: (1) it did not have the authority to authenticate the notes since it did not have in its possession a resolution from the issuing corporation authorizing the issuance; and (2) a legal opinion was not filed or delivered to Union Bank. The trustee thereby allegedly violated § 207(b) of the bond indenture which had been incorporated by §§ 103 and 105 of the supplemental indenture.[14]

[4] As with the two previous motions, the court believes that some material issues of fact have yet to be resolved, so that it would not be proper to grant plaintiff noteholders' motion for summary judgment pursuant to Rule 56. In regards to the certificate of authentication issue, neither side has convinced the court as to what significance is placed on a certificate such as the one present here.[15] Union Bank's scienter is also an issue to be resolved by the jury.[16]

And for the reasons specified in Sections (I)(C)(2) and (I)(C)(3) of this order, the court concludes that plaintiff noteholders' allegations concerning Union Bank's participation in the fraudulent scheme and its role as a statutory underwriter are not ripe for summary judgment. Accordingly, plaintiff noteholders' motion for summary judgment is denied.

IV. *DEFENDANT GIBRALCO, INC. AND GUNTHER'S MOTION TO DISMISS/FOR SUMMARY JUDGMENT AGAINST PLAINTIFFS.*

On May 25, 1979, the court heard the motions of Gibralco, Inc. (hereinafter Gibralco) and Charles L. Gunther to dismiss/for summary judgment and to vacate the class certification order. In an order dated June 7, 1979, the court denied the latter motion and denied the former motion only with respect to the antifraud claims. With respect to the claim under Securities Act of 1933 § 12(2), *15 U.S.C.*

14. The court agrees with the noteholders that § 207 of the bond indenture was incorporated by §§ 103 and 105 of the supplemental indenture. Section 103 provided that the notes were to be "authenticated by the Trustee in substantially the same manner as required for the bonds pursuant to Section 204 of the Indenture."

Section 204 provided:

> Only such of the Bonds as shall have endorsed thereon a certificate of authentication substantially in the form set forth in Exhibit C [sic] hereto, duly executed by the Trustee, shall be entitled to any rights, benefits, or security under this Indenture. No bonds, and no coupon appertaining to any Bond, shall be valid or obligatory for any purpose unless and until such certificate of authentication shall have been duly executed by the Trustee, and such certificate of the Trustee upon any such Bond shall be conclusive and the only evidence that such Bond has been duly authenticated and delivered under this Indenture.

Implicit in § 204 was compliance with § 207, which provided:

> [B]efore said Bonds shall be authenticated and delivered by the Trustee there shall be filed with or delivered to the Trustee the following [*see* note 2 *supra*]. . .

Authentication by the Trustee was not an isolated act, but rather dependent upon the satisfaction of various conditions.

15. *See* Section (I)(C)(1) *supra*.

16. It is not clear whether there were irregularities in the procedures followed prior to the issuance of the note's certificate of authentication. As noted, plaintiffs maintain that no resolution of the issuer (Facilities Corporation), certified by its Secretary and directing the issuance and authentication of the notes, was ever executed and thus does not exist in Union Bank's files. Defendant Union Bank counters by directing the court's attention to Mr. Schreiber's Supplemental Declaration, Exhibit 13, which is an *unsigned* copy of the required resolutions, and Exhibit 12, which is a copy of the minutes of a meeting held July 9, 1974 during which time those directors present voted in favor of the resolution and supplemental indenture (a copy of which appears in Exhibit 13).

Plaintiffs also claim that the note opinion given by Urban Schreiner was not the same as the one that appeared on each of the notes. The court has examined both and concludes that the contents are the same, although the one on the notes was signed by Rogers & Schreiner, while the other was not signed.

Finally, it does not appear that the opinion appearing on the notes fulfilled the requirements of § 207 of the bond indenture, which the court has concluded was incorporated by the supplemental indenture.

§ 77l(2), the court deferred judgment and requested that the parties submit additional briefs concerning: (1) whether any privity existed between defendants and named plaintiffs; and (2) whether the bond and note certificates, opinions of counsel, and the certificate of authentication constituted a prospectus. The matter is now before the court for consideration of the supplemental papers.

Gibralco is a municipal bond house which purchased $565,000 in bonds and $200,000 in notes from underwriters and resold them to the investing public. Gunther, president and majority stockholder of Gibralco, purchased the bonds and notes on Gibralco's behalf.

A. *CERTIFICATE AS A PROSPECTUS*

In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756, 95 S.Ct. 1917, 1935, 44 L.Ed.2d 539 (1975), *reh. denied*, 423 U.S. 884, 96 S.Ct. 157, 46 L.Ed.2d 114 (1975), Justice Powell wrote, "The starting point in every case involving construction of a statute is the language itself." Federal law defines a "prospectus" as "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which [1] offers any security for sale or [2] confirms the sale of any security." *15 U.S.C. § 77b(10).*

The term "offer for sale" includes "every attempt or offer to dispose of, or solicitation of any offer to buy a security or interest in a security, for value." *15 U.S.C. § 77b(3).*

[5] Civil liability may attach to the issuance of a false or misleading prospectus. Securities Act of 1933 § 12(2), *15 U.S.C. § 77l(2)* provides, in pertinent part, that any person who:

> offers or sells a security by the use of any means . . . in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . .
> shall be liable to the person purchasing such security from him . . . .

Plaintiffs maintain that the bond and note certificates, bond/note counsel's opinion, and Union Bank's certificate of authentication, taken either singly or collectively as one document, should be held to constitute a prospectus within the definition of that term as found in *15 U.S.C. § 77b(10).*[17] Plaintiffs primarily rely on *Baron v. Commercial & Indus. Bank of Memphis*, [1979] Fed.Sec.L.Rep. (CCH) ¶ 96.826, at 95,307–308 (S.D.N.Y.1979) which found that a bond opinion printed on each bond certificate that was mailed to purchasers after the sale was completed, "constitute[d] a 'prospectus' within the meaning of § 12(2)."

[6] The court cannot agree with the court's opinion in *Baron*, which cited no authority for its conclusion, and finds that the bond and note certificates, which contained the opinion of counsel and the trustee's certificate of authentication, do not constitute a prospectus under the 1933 Act. The court reaches the conclusion for two reasons.

1. *Offer for Sale*

First, the court has carefully examined the bond and note certificates in question

17. Plaintiffs assert a cause of action under § 12(2) in paragraphs 52–60 of the consolidated amended complaint. *Plaintiffs' Memorandum in Opposition to the Motion of MuniciCorp and Charles L. Gunther to Dismiss and for Summary Judgment* at 28. In paragraph 52, plaintiffs allege that defendants Schreiner and Nichols, Rogers & Schreiner (in the case of the bonds), and Schreiner and Rogers & Schreiner (in the case of the notes), as well as Union Bank as trustee in both issuances, made statements on every bond and note certificate which were materially false or misleading or omitted to state material facts necessary to make the statements not misleading. In paragraphs 53–58, plaintiffs elaborate as to the falsity and omissions of these statements. In paragraph 60, plaintiffs allege that all of the defendants knew, or should have known and ignored in reckless disregard of the truth the facts set forth in paragraphs 52–58. There is no allegation in the consolidated amended complaint of oral communications within the definition of § 12(2).

and cannot find anything in the documents which "offers any security for sale" within the meaning of *15 U.S.C. §§ 77b(3) & (10).* The bond/note certificates themselves do not attempt to dispose of securities or solicit any offers to buy them. Instead, they embody an agreement between the Facilities Corporation and the purchaser, and set forth terms including the payment of interest, redeemability and maturity, transferability, authenticity, and ownership.

Likewise, the certificate of authentication and the accompanying opinion letter do not fall within the definition of a prospectus. The opinion letter essentially outlines the documents examined, the research conducted, and the conclusions reached concerning the issuance of the bonds and notes. The certificate of authentication merely proclaims that the bonds/notes have been issued in accordance with the indenture. Neither the certificate of authentication nor the opinion letter attempt to dispose of securities or solicit any offers.

Furthermore, the mere fact that the three items appear on one document is inconsequential. Since each item taken individually is not a prospectus, and there is nothing remarkable about the organization of the instrument, it necessarily follows that lumping them together does not change their nature. Thus, the first prong of *15 U.S.C. § 77b(10)*—offer a security for sale—is not satisfied.

2. *Confirm the Sale*

Second, the court does not find that the three items examined previously "confirm the sale of any security" within the meaning of *15 U.S.C. § 77b(10).* To understand the court's decision, one must conduct a brief review of the statute's legislative history.

The Securities Exchange Act of 1934 § 11(d)(2), *15 U.S.C. § 78k(d)(2)* provides, in pertinent part, that it is unlawful for a member of a national securities exchange, who is both a dealer and a broker, or for any person who both as a broker and a dealer transacts a business in securities through the medium of a member, to use a national securities exchange or interstate commerce to effect any transaction unless, if the transaction is with a customer, he discloses to such customer in writing, at or before the completion of the transaction, whether he is acting as a dealer for his own account, as a broker for such customer, or as a broker for some other person. The instrument for disclosure is called a "confirmation." [18]

The confirmation is a product of several federal provisions. Under Securities Exchange Act of 1934 § 15, *15 U.S.C. § 78o (c)(1),* the Securities Exchange Commission (hereinafter the SEC) is granted the power to define, by rules and regulations, devices or contrivances which are manipulative, deceptive or otherwise fraudulent. The SEC, pursuant to that power, has enacted several rules, including Rule 15c1–4, *17 C.F.R. § 240.15c1–4 (1975),*[19] which requires the giving or sending of "a written confirmation," at or before the completion of each over-the-counter transaction with a customer, disclosing whether the broker-dealer is acting as a dealer for his own account or as a broker for either or both sides. 3 L. Loss, *Securities Regulation* 1477 (2d ed. 1961).

The concept of a written confirmation made its first appearance in the Securities Exchange Act of 1934. Consequently, the Securities Act of 1933 did not contain the phrase "or confirms the sale of any security." These words were not added to the Securities Act until 1954 when Congress amended the statute to read as it does today. The reason for the additional phrase was "to avoid any implication of departure from settled interpretations that confirmations are prospectuses." [1954] *U.S.Code Cong. & Admin.News,* pp. 2973, 2994. It is therefore apparent that when Congress amended the Act, it merely intended to clarify that a broker/dealer's written confirmation constituted a prospectus.

18. *See* Rule 15c1–4 (17 C.F.R. § 240.15c1–4).

19. *See* note 18 *supra.* The heading of § 240.15c1–4 is "Confirmation of Transactions."

After examining the bond/note certificates with their accompanying opinion letters and certificates of authentication, it is clear to the court that none of the items served as confirmations as defined above so that they did not "confirm the sale of any security" within the meaning of *15 U.S.C. § 77b(10)*. Thus, the second prong is not satisfied, and the three items, whether viewed individually or collectively, do not amount to a prospectus.[20]

B. *PRIVITY*

Since the court has concluded that the bond/note certificates and their accompanying documents did not constitute a prospectus, and there has been no allegation of oral communication as envisioned in § 12(2), *15 U.S.C. § 77l(2)*, the court need not examine the privity arguments. Accordingly, Gibralco's and Gunther's motion to dismiss/for summary judgment is granted.

V. *THIRD-PARTY DEFENDANT WILKINS' MOTION TO DISMISS AGAINST THIRD-PARTY PLAINTIFF UNION BANK.*

As noted earlier, Union Bank was the bond/note indenture trustee. On May 14, 1979, it filed an amended third-party complaint against a number of individuals, including Theodore E. Wilkins. Third-party defendant Wilkins is Executive Vice-President and Treasurer of Oxford Life Insurance Co., the entity which acquired, and then subsequently retired, the bond anticipation note issued by the Facilities Corporation. The complaint alleges, among other things, that Mr. Wilkins and others violated certain securities laws, and seeks indemnity, partial indemnity, and contribution from Mr. Wilkins. Mr. Wilkins responded to this complaint by filing the motion to dismiss which is now before the court.

A. *MINIMUM CONTACTS*

[7] Distilled to its essentials, defendant Wilkins' position is that since the "minimum contacts" doctrine of *International Shoe* applies to a federal securities fraud action in this circuit and since he was never in this state on business regarding the matters which are the subject of this litigation, then the third-party complaint should be dismissed because there is no *in personam* jurisdiction, irrespective of § 27 of the Securities Exchange Act.[21] The court does not agree.

The Supreme Court, in *International Shoe Co. v. Washington*, 326 U.S. 310, 316, 66 S.Ct. 154, 158, 90 L.Ed. 95 (1945) held that:

> due process requires only that in order to subject a defendant to judgment in personam, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend "traditional notions of fair play and substantial justice."

More recently, the Court in *Shaffer v. Heitner*, 433 U.S. 186, 97 S.Ct. 2569, 53 L.Ed.2d 683 (1977) extensively discussed the restraints which due process imposes on jurisdictional power and concluded "that all assertions of state-court jurisdiction must be evaluated according to the standards set forth in *International Shoe* and its progeny." *Id.* at 212, 97 S.Ct. at 2584.

Both *International Shoe* and *Shaffer* spoke directly of state court jurisdiction. One of the most complete and thorough examinations of the restrictions that due

20. In general, a prospectus relating to a security issued by other than a foreign government shall include the same information required to be included in a registration statement except for certain documents referred to in the schedules. A prospectus is subject to the SEC's power to adopt rules adding, subtracting, and classifying information. 15 U.S.C. § 77j(a)(1); 69 Am.Jur.2d Securities Regulation—Federal § 169 (1973); 1 L. Loss, *Securities Regulation* 317 (2d ed. 1961). The information demanded in a registration statement (*see* Schedule A, 15 U.S.C. § 77aa), and therefore a prospectus, is more comprehensive than that which appeared in the bond/note certificates and their accompanying papers. This fact reinforces the court in its decision that the latter items were not to serve as a prospectus.

21. *See* note 22 *infra*.

process might impose on federal jurisdiction over persons is found in *Fitzsimmons v. Barton*, 589 F.2d 330 (7th Cir. 1979).

In *Fitzsimmons*, a securities fraud case, the district court relied on that part of *F.R.Civ.P. 4(e)* requiring that if no statute of the United States provides for the manner of service, then service is governed by the law of the state in which the district court sits, and therefore dismissed a party since the court concluded that the Illinois long-arm statute did not have sufficient reach. The Seventh Circuit reversed saying that reference to Illinois law was inappropriate in this case. Instead, the court based jurisdiction on the congressional authorization of nationwide service of process—Securities Exchange Act of 1934 § 27, *15 U.S.C. § 78aa* [22]—and found that this section satisfied Rule 4(e). Therefore, the only question before the court was "whether the Due Process Clause imposes any restraints on this nationwide service." *Id.* at 332.

After examining *Shaffer* and *International Shoe*, the court concluded:

> It is clear, therefore, that the "fairness" standard imposed by *Shaffer* relates to the *fairness of the exercise of power by a particular sovereign*, not the fairness of imposing the burdens of litigating in a distant forum. Applying this standard of fairness, it is clear that this instance of personal service satisfies Due Process. Here the sovereign is the United States, and there can be no question but that the defendant, a resident citizen of the United States, has sufficient contacts with the United States to support the fairness of the exercise of jurisdiction over him by a United States court.

Id. at 333 (emphasis added). In other words, when Congress authorizes nationwide service, as in § 27, the question becomes whether the party has sufficient contacts with the United States, not any particular state. *Accord, Mariash v. Morrill*, 496 F.2d 1138, 1143 (2d Cir. 1974) ("where . . . the defendants reside within the territorial boundaries of the United States, the 'minimal contacts' required to justify the federal government's exercise of power over them, are present"); *Warren v. Bokum Resources Corp.*, 433 F.Supp. 1360, 1364 (D.N.M.1977); *B & B Inv. Club v. Kleinert's Inc.*, 391 F.Supp. 720, 728 (E.D.Pa.1975) (in a federal securities fraud case, reliance on the due process requirements of *International Shoe* was misplaced because that decision involved extraterritorial service in a state court action under a state statute); *Sarratt v. Walker*, 405 F.Supp. 132, 133 (D.S.C.1975) (Congress' purpose in enacting § 27 was to extend personal jurisdiction to the full limits permitted by the due process clause); *Sohns v. Dahl*, 392 F.Supp. 1208, 1218 (W.D.Va.1975); *Kramer v. Scientific Control Corp.*, 365 F.Supp. 780, 787 (E.D.Pa. 1973) (Congress has the power to provide for the reach of service of process to the outer limits of the reach of its legislative power, which is anywhere in the United States or its territories); *S–G Securities, Inc. v. Fuqua Inv. Co.*, 466 F.Supp. 1114 [1979] Fed.Sec.L.Rep. (CCH) ¶ 96,750, at 94,-932 (D.Mass.1978) (the *International Shoe* standard is applicable only where a state court asserts jurisdiction over an out-of-state defendant pursuant to the state's long-arm statute). *See Leroy v. Great Western United Corp.*, 443 U.S. 173, 99 S.Ct. 2710, 2721, 61 L.Ed.2d 464 (1979) (White, J. dissenting). *But see In re Equity*

22. Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78aa provides, in pertinent part:

> The district courts of the United States, and the United States courts of any territory or other place subject to the jurisdiction of the United States shall have the exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.

Funding Corp. of Amer. Sec. Litigation, 416 F.Supp. 161, 177–78 (C.D.Cal.1976).[23]

Applying the rule of *Fitzsimmons* to the case at bar, the court finds *in personam* jurisdiction since defendant Wilkins certainly had "minimum contacts" with the United States.[24] Jurisdiction in this case is founded on § 27 of the Securities Exchange Act and § 22 of the Securities Act, *15 U.S.C. § 77v*, which both permit service throughout the United States. The fact that Union Bank brings this action through a third party complaint is inconsequential. *See Lyons v. Marrud*, 46 F.R.D. 451, 455 (S.D.N.Y.1968).

B. *CAPACITY OF WILKINS*

Defendant Wilkins also moves for dismissal on the theory that he is not subject to the personal jurisdiction of the forum since if he had any contact with the forum, it only occurred while he was acting in his official capacity as Vice-President and Treasurer of Oxford Life Insurance Co. He cites *Forsythe v. Overmyer*, 576 F.2d 779 (9th Cir. 1978), *cert. denied*, 439 U.S. 864, 99 S.Ct. 188, 58 L.Ed.2d 174 (1979), in which the Ninth Circuit decided that "a corporate officer who has contact with the forum only with regard to his official duties is not subject to personal jurisdiction in that forum." *Id.* at 783–84 (citing *Chem Lab Prod., Inc. v. Stepanek*, 554 F.2d 371 (9th Cir. 1977)). In *Kaltsas v. Giffen Indus., Inc.*, [1978] Fed.Sec.L.Rep. (CCH) ¶ 96,445, at 93,599 (S.D.N.Y.1978), the district court applied reasoning similar to *Forsythe* to a shareholder's diversity action and said: "Without some factual allegation of involvement in an individual capacity, the shareholders . . . failed to make a threshold showing of jurisdictional basis."

All three of the cases cited by defendant Wilkins were diversity actions. Neither side has adequately addressed the issue of what impact they would have on a federal securities fraud case which bases personal jurisdiction on § 27 of the Securities Exchange Act and § 22 of the Securities Act, two provisions that provide for nationwide service of process so that a party must merely have "minimum contacts" with the United States. The parties may brief this issue and submit their briefs within twenty-one days of this order. They are to arrange a briefing schedule among themselves.

Accordingly, defendant Wilkins' motion is denied subject to reconsideration after further briefing.

VI. *THIRD-PARTY DEFENDANTS PACKARDS' AND PRAHM'S MOTION TO DISMISS THIRD-PARTY COMPLAINT OF DEFENDANT HAROLD E. ROGERS OR MOTION FOR A MORE DEFINITE STATEMENT.*

Third-party defendants Packards and Prahm (hereinafter the Packard group) were members of the investor group that owned Quimby Island and who participated in the allegedly fraudulent scheme to sell the property to the Reclamation District through the issuance of securities that are the subject of this lawsuit. Defendant and third-party plaintiff, Harold E. Rogers, Jr., was an officer of the professional law corporation, Nichols, Rogers & Schreiner, when another officer, Schreiner, issued an opinion on the Quimby Island bonds. He was also Schreiner's partner in Rogers & Schreiner when the latter issued a note opinion. In the consolidated amended complaint, defendant Rogers is alleged to have participated in the previously mentioned fraudulent scheme. More specifically, he is

23. The court placed little emphasis on this case because the district court in *Equity Funding* never really analyzed the question of whether the "minimum contacts" theory applied. It said: "This court finds the alleged partnership interest of these defendants in the Wolfson firm is sufficient to support jurisdiction over these defendants. This is true *even under* the 14th Amendment 'minimum contacts' analysis of *International Shoe* ..." (Emphasis added.) 416 F.Supp. at 177–78. The Ninth Circuit has yet to address the issue.

24. The court in *Manash* believed that only in the case of extraterritorial service of process does the question of a forum's power to assert control over a defendant arise. 496 F.2d at 1143.

charged with violating Securities Act of 1933 §§ 17(a), *15 U.S.C. § 77q(a)*,[25] 12(2), *15 U.S.C. § 77l(2)*,[26] Securities Exchange Act of 1934 § 10(b), *15 U.S.C. § 78j(b)*,[27] and Rule 10b-5, *17 C.F.R. 240.10b-5* (1979).[28] On July 19, 1979, Rogers brought a third-party complaint against the Packard group seeking contribution and indemnity. This matter is before the court on the Packard group's motion to dismiss, or in the alternative, motion for a more definite statement.

The Packard group asserts (1) that defendant Rogers fails to state a claim for indemnity since the equitable indemnity doctrine was adopted in California only so that a person may recover, under a negligence or strict liability theory, damages for injuries to his person and property; (2) that defendant Rogers fails to state a claim for contribution since the Packard group was not named as an original defendant and since an essential element of the underlying claim is that the third-party plaintiff intentionally harmed plaintiffs; and (3) that they have been prejudiced by defendant Rogers' delay in bringing the third-party complaint. The court will examine each assertion in order.

A. *MOTION TO DISMISS*

1. *Indemnification*[29]

a. *Federal Securities Laws*[30]

i. *Section 10(b) and Rule 10b-5*

Section 10(b) of the Securities Exchange Act of 1934 confers rule-making power upon the SEC to condemn manipulative or deceptive practices in the sale or purchase of securities. Although it does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy, the existence of a private cause of action for violations of the statute and the rule is now well established. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975), *reh. denied*, 423 U.S. 884, 96 S.Ct. 157, 46 L.Ed.2d 114 (1975); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972), *reh. denied*, 407 U.S. 916, 92 S.Ct. 2430, 32 L.Ed.2d 692 (1972); and *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9, 92 S.Ct. 165, 169 n.9, 30 L.Ed.2d 128 (1971).

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668, *reh. denied*, 425 U.S. 986, 96 S.Ct. 2194, 48 L.Ed.2d 811 (1976), the Supreme Court found that § 10(b) and its corresponding rule were addressed to practices that involve some element of "scienter," which was defined as a "mental state embracing intent to deceive, manipulate, or defraud." *Id.* at 193 n.12, 96 S.Ct. at 1381 n.12. The Court specifically reserved the question of whether reckless behavior was sufficient for civil liability under § 10(b) and Rule 10b-5, *id.*, but did conclude that the two provisions could not be read to impose liability for negligent conduct alone. *Id.* at 201, 96 S.Ct. at 1384.

After the *Ernst & Ernst* decision, many courts had to confront the question concerning reckless conduct. In *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir.), *cert. denied*, 439 U.S. 970, 99 S.Ct. 464, 58 L.Ed.2d 431 (1978), the Ninth Circuit stated:

> *Ernst & Ernst*, we think, only went so far as to eliminate negligence as a basis for liability. We agree with those courts which have found that Congress intended the ambit of § 10(b) to reach a broad category of behavior, including knowing and reckless conduct.

25. *See* note 5, *supra*, for the contents of the section. See court's discussion of that provision in Section (VI)(A)(1)(a)(i).

26. *See* Section (IV)(A), *supra*.

27. *See* note 6, *supra*.

28. *See* note 7, *supra*.

29. The court expresses no opinion about the partial indemnity claims since they were never challenged by any party.

30. Indemnification for violation of the federal securities laws is a matter of federal, not state, law. *Odette v Shearson, Hammill & Co.*, 394 F.Supp. 946, 954 n.9 (and cases cited therein.)

This conclusion has been reached in the second,[31] third,[32] fifth,[33] sixth,[34] and seventh circuits,[35] and several district courts.[36]

It is not necessary for the court to precisely define what constitutes reckless behavior since it is ultimately a factual determination which will vary from case to case. As a general matter, the court agrees with the standard articulated in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U.S. 875, 98 S.Ct. 224, 54 L.Ed.2d 155 (1977), which stated that recklessness is highly unreasonable conduct representing an extreme departure from the standards of ordinary care. *Accord, Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979); *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977) ("We believe 'reckless' in these circumstances comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence.")

[8] Thus, if defendant Rogers is found liable for violating § 10(b) or Rule 10b-5, then the jury must find that he acted "intentionally" as defined in *Ernst & Ernst*, or "recklessly" as defined in *Sundstrand*. In either event, indemnification would be improper since the policy of the securities laws precludes indemnification in all except extraordinary circumstances, such as the indemnification of a corporation by its officers or directors who caused it to engage in the conduct giving rise to the liability. *In re Equity Funding Corp. of America*, 416 F.Supp. 132, 156 (C.D.Cal.1975); *Thomas v. Duralite Co.*, 386 F.Supp. 698 (D.N.J.1974), *aff'd in part*, 524 F.2d 577 (3d Cir. 1975). The weight of authority establishes that indemnification against actual wrongdoing as contrasted with negligent conduct is considered void. *See Odette v. Shearson, Hammill & Co.*, 394 F.Supp. 946, 964 (S.D.N.Y. 1975); *Globus v. Law Research Serv. Inc.*, 287 F.Supp. 188 (S.D.N.Y.1968), *aff'd*, 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913, 90 S.Ct. 913, 25 L.Ed.2d 93 (1970); *Tucker v. Arthur Andersen & Co.*, [1973-74] Fed.Sec.L.Rep. (CCH) ¶ 94,544 (S.D.N.Y.1974). Therefore, defendant Rogers could not be indemnified if he is found liable under § 10(b) or Rule 10b-5.

ii. *Section 17(a)*

There is disagreement over whether there is a private cause of action under § 17(a).[37] *Compare Daniel v. Teamsters*, 561 F.2d 1223, 1244-46 (7th Cir. 1977), *rev'd on other grounds*, 439 U.S. 551, 99 S.Ct. 790, 58 L.Ed.2d 808 (1979) (recognizing an action) *with Shull v. Dain, Kalman & Quail, Inc.*, 561 F.2d 152, 159 (8th Cir. 1977), *cert. denied*, 434 U.S. 1086, 98 S.Ct. 1281, 55 L.Ed.2d 792 (1978) (rejecting a § 17 cause of action). *See also* 3 L. Loss, *Securities Regulation* 1784-85 (2d ed. 1961). There appears, however, to be little practical point in denying the existence of an action under § 17 once it is established that an aggrieved person has a private cause of action under § 10(b) of the 1934 Act. *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1283-84 (2d Cir. 1969); *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976, 89 S.Ct. 1454, 22 L.Ed.2d 756 (1969), 404 U.S. 1005, 92 S.Ct. 561, 30 L.Ed.2d 558 (1971); *Local 734 Trust v. Continental Ill. Nat'l*

31. *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44 (2d Cir.), *cert. denied*, 439 U.S. 1039, 99 S.Ct. 642, 58 L.Ed.2d 698 (1978).

32. *Coleco Indus., Inc. v. Berman*, 567 F.2d 569, 574 (3rd Cir. 1977), *cert. denied*, 439 U.S. 830, 99 S.Ct. 106, 58 L.Ed.2d 124 (1978).

33. *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied*, 435 U.S. 952, 98 S.Ct. 1580, 55 L.Ed.2d 802.

34. *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979)

35. *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1039-40 (7th Cir.), *cert. denied*, 434 U.S. 875, 98 S.Ct. 224, 54 L.Ed.2d 155 (1977).

36. *See, e. g., Sullivan v. Chase Inv. Serv. of Boston, Inc.*, 79 F.R.D. 246, 270 (N.D.Cal.1978); *In re Transocean Tender Offer Securities Litigation*, 455 F.Supp. 999, 1010-11 (N.D.Ill.1978).

37. The Supreme Court specifically reserved answering this question in *Daniel v. Teamsters*, 439 U.S. 551, 557 n.10, 99 S.Ct. 790, 795 n.10, 58 L.Ed.2d 808, 815 n.10 (1979).

Bank & Trust Co., [1973–74] Fed.Sec.L.Rep. (CCH) ¶ 94,565, at 95,962–963 (N.D.Ill.1974).

Yet the court need not resolve this dispute[38] since, even assuming an action exists, the weight of authority holds that scienter must be present so that the cause of action cannot be premised on negligent conduct alone. *Sanders v. John Nuveen & Co.*, 554 F.2d at 796 (and cases cited therein); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d at 867 (Friendly, J. concurring); *Malik v. Universal Resources Corp.*, 425 F.Supp. 350, 363 (S.D.Cal.1976).[39] To follow a lesser standard "would totally undermine the carefully framed limitations imposed on the buyer's right to recover granted by § 12(2) of the 1933 Act." *SEC v. Texas Gulf Sulphur*, 401 F.2d at 867–68 (Friendly, J. concurring). *See* 3 L. Loss, *Securities Regulation* 1785 (2d ed. 1961). Thus, if defendant Rogers is found liable under § 17(a), the jury will have to find that he acted more than negligently, and as noted earlier, indemnification is not permissible under such circumstances.

iii. *Section 12(2)*

[9] Since the court has already examined this section at length when deciding Gibralco and Gunther's motion, it need not fully explore its dimensions again. What should be noted, however, is that one may violate this section even if he is merely negligent. *Franklin Sav. Bank of New York v. Levy*, 551 F.2d 521, 526–27 (2d Cir. 1977); *Rousseff v. Dean Witter & Co.*, 453 F.Supp. 774 (N.D.Ind.1978); *Odette v. Shearson, Hammill & Co.*, 394 F.Supp. at 966. In spite of this, there is disagreement over whether indemnification is proper if a party is found to have violated § 12(2). For example, the court in *Odette* denied indemnification to encourage the conduct required by § 12(2), while the court in *Globus* found that indemnification was permissible for conduct that was no more culpable than ordinary negligence.

The court sees no sense in adding to the confusion of the state of the law or of this case by deciding whether or not indemnification is proper in a § 12(2) case. This issue will not arise unless defendant Rogers is found liable for violating § 12(2) so it is a matter that can wait until the end of trial when the record is complete.[40]

b. *State Law*

The consolidated amended complaint also alleges that defendant Rogers violated *Cal. Corp.Code* (West) §§ 25401 and 25501, provisions which prohibit negligent misrepresentation. *Bowden v. Robinson*, 67 Cal. App.3d 705, 715, 136 Cal.Rptr. 871 (1977). Defendant Rogers seeks indemnity for these provisions and others.[41]

[10, 11] "Generally, indemnity becomes a consideration when one person is exposed to liability because of what another person did . . . [T]he determination of whether or not indemnity should be allowed must of necessity depend upon the facts of each case . . . The right to non-contractual implied indemnity rests upon *equitable* considerations. *Atchison, T. & S. F. Ry. Co. v. Lan Franco*, 267 Cal.App.2d 881, 886–87, 73 Cal.Rptr. 660, 663 (1968).

38. Neither side has briefed this point, and it is not necessary to resolve it for the purposes of this motion.

39. In *SEC v. Coven*, 581 F.2d 1020, 1026–27 (2d Cir. 1978), cert. denied, 440 U.S. 950, 99 S.Ct. 1432, 59 L.Ed.2d 640 (1979), the Second Circuit concluded that scienter was not required in an SEC injunctive action under subsection 17(a)(2). *Accord*, *SEC v. American Realty Trust*, 586 F.2d 1001, 1006 (4th Cir 1978). The Fifth Circuit, in *Steadman v. SEC*, 603 F.2d 1126, 1132–33 (5th Cir. 1979) held that scienter need not be proved to establish violations of §§ 17(a)(2) and (3), but is an element of § 17(a)(1).

40. The court has decided in Section (IV)(A) that the bond/note certificate, the opinion letter, and the certificate of authentication do not, individually or collectively, constitute a prospectus. The matter may never present itself.

41. Cal.Corp.Code (West) § 25505 provides for indemnification in limited circumstances: "A corporation which is liable under this chapter shall have a right of indemnification against any of its principal executive officers, directors, and controlling persons whose willful violation of any provision of this law gave rise to such liability." Such is not the case here.

[12] "[T]wo critical prerequisites are generally necessary for the invocation of non-contractual implied indemnity in California: (1) the damages which the claimant seeks to shift are imposed upon him as a result of some legal obligation to the injured party; and (2) it must appear that the claimant *did not actively nor affirmatively participate* in the wrong." Id. at 887, 73 Cal.Rptr. at 664.

The court is not in a position at this time to determine on the basis of the meager record presented whether or not indemnification is proper. Since this issue will arise only if liability is found after trial, the court will resolve the matter at that time. To do so now would be premature.[42]

2. *Contribution*

a. *Federal Securities Laws*

As noted, the Packard group maintains that there is no right to contribution since it was not named as an original defendant and since an essential element of the underlying claim is that the third-party plaintiff intentionally harmed plaintiffs. The court does not agree.

[13-15] Contribution is generally available in federal securities fraud cases.[43] *Odette v. Shearson, Hammill & Co.*, 394 F.Supp. at 957-58; *deHaas v. Empire Petroleum Co.*, 286 F.Supp. 809, 815-16 (D.Colo.1968), *mod. on other grounds*, 435 F.2d 1223 (10th Cir. 1970). And a claim for contribution may be asserted in a third party action pursuant to F.R.Civ.P. 14(a). *Odette v. Shearson, Hammill & Co.*, 394 F.Supp. at 958 (and cases cited therein). In fact, the deterrent policies of the securities laws that preclude indemnification prompt the conclusion that no party be allowed to escape liability for any part of the damages. *See id.* Correspondingly, a party is permitted to receive contribution, even if found to have violated § 10(b), Rule 10b-5, § 17(a), and § 12(2). *Id.* *See Globus, Inc. v. Law Research Serv., Inc.*, 318 F.Supp. 955 (S.D. N.Y.1970), *aff'd*, 442 F.2d 1346 (2d Cir.), *cert. denied*, 404 U.S. 941, 92 S.Ct. 286, 30 L.Ed.2d 254 (1971); *deHaas v. Empire Petroleum Co.*, 286 F.Supp. at 815-16.

Accordingly, contribution is permitted under federal law.

b. *State Law*

[16] As noted earlier, the consolidated amended complaint alleges that defendant Rogers violated Cal.Corp.Code (West) §§ 25401 and 25501. A statutory right to contribution is granted to those charged with violating these sections, Cal.Corp.Code (West) § 25505, 2 Ballantine & Sterling, *California Corporation Law* § 463.07, at 932.47 (1979), as long as the person requesting contribution was not a wilfull violator seeking contribution from a person who was negligent. Since the record is insufficient to determine the culpability, if any, of the defendants, the court finds that defendant Rogers may claim contribution at this stage. The Packard group's motion is denied as to this point.[44] *See* 1 Marsh & Volk, *Practice Under the California Securities Law* § 14.08[3], at 14-9 (rev. ed. 1979).

3. *Prejudice*

Third-party plaintiff Rogers filed his answer to the amended complaint on March 20, 1979, and moved for leave to file the third-party complaint on April 30, 1979. In its written order of June 7, 1979 (filed June 12, 1979), the court granted defendant Rogers leave to file the proposed third-party

42. The court should note that the cases cited here and those in the moving papers are not securities cases. The court is therefore not convinced that their principle permitting indemnification is applicable to the securities field. In any event, this issue may await resolution at a later time.

43. Like indemnification, contribution in a federal securities case is a matter of federal law. *Odette v. Shearson, Hammill & Co.*, 394 F.Supp. at 958; *Globus, Inc. v. Law Research Serv. Inc.*, 318 F.Supp. 955, 958, n.2 (S.D.N.Y. 1970). The Packard group's citation of California law, although thorough, is of no relevance to the alleged federal securities violations.

44. A motion to dismiss a complaint should not be granted if material issues of fact are unresolved. *Powell v. Southwestern Bell Tel. Co.*, 494 F.2d 485, 489 (5th Cir. 1974).

complaint because the court found that the complaint "will not prejudice the plaintiff by introducing an unrelated controversy or unduly complicating this litigation. Moreover, it will avoid circuity of actions, thereby promoting economies of time and expense." The Packard group objects to the filing of the third party complaint because it claims that the complaint was tardy and that they are now unduly prejudiced since the court permitted it. The Packard group was apparently served with notice of the motion, but did not oppose it. The court sees no reason to change its earlier decision.

In the first place, the court does not feel that the third-party complaint was untimely. The original complaint in this lawsuit was filed on April 15, 1977, by the representatives of the bondholders. On November 23, 1977, a complaint was filed by the representatives of the noteholders as plaintiffs in intervention. The complaints were somewhat imprecise, so in its order of June 9, 1978, the court ordered plaintiffs to submit a list of the various statutes which they claimed defendants violated together with a brief statement describing how each was violated. Shortly thereafter, the representatives of the two classes of securities investors combined their claims into one pleading—the consolidated amended complaint—which was filed on November 9, 1978.

Nichols, Rogers, and Schreiner and their corporation and partnership were initially represented in this action by the same law firm. During 1978, potential conflicts developed among the individuals, and between them and the corporation and partnership. The individuals were thus prompted to obtain separate counsel. Present counsel of record for Harold Rogers did not assume representation until January 19, 1979. As noted, Mr. Rogers' answer was filed on March 20, 1979, a reasonable time considering the complexity and sheer volume of this case.

On April 17, 1979, the deposition of Mr. Max Mortensen, the general manager of the Quimby Island Reclamation District and Facilities Corporation, commenced. Mr. Mortensen had been unavailable prior to that time because of a pending criminal prosecution against him before the SEC. During Mr. Mortensen's deposition, certain facts were confirmed or revealed, facts upon which Mr. Rogers bases his third-party claims. Thirteen days after the deposition began, Mr. Rogers filed his third-party complaint.

[17] The court is granted a broad discretion in determining whether to allow a third party complaint. 3 Moore's *Federal Practice* ¶ 14.05[2], at 14–196 (2d ed. 1979). In light of the above, the court concludes that the delay was understandable and excusable and that the trial will not be delayed or made unduly complicated. Any possible prejudice to the Packard group will be outweighed by the utility of having all aspects of this litigation decided in one proceeding. *See B & B Inv. Club v. Kleinert's, Inc.*, 391 F.Supp. at 725.

Secondly, the court is not persuaded by the Packard group's argument concerning the release of all claims granted to them by the Bankruptcy Trustee in the District's bankruptcy court proceedings. It appears that on February 10, 1978, the Packard group consented to the bankruptcy plan in exchange for the release of all claims held by the District against the Packard group. But the District release had no impact on the claims brought by third-party plaintiff Rogers. The release became effective June 6, 1978, and Rogers was neither a party to the bankruptcy proceedings nor notified that such a proceeding had been instituted. Therefore, the court does not see why the Packard group's release should have any bearing on Rogers' third-party complaint.

[18] Accordingly, the Packard group's motion to dismiss is denied.

B. *MOTION FOR A MORE DEFINITE STATEMENT*

[19–21] If a party cannot reasonably be required to frame an answer because the complaint is too vague or ambiguous, he may move for a more definite statement before answering. F.R.Civ.P. 12(e). The pleading must contain a short and plain statement of the claim showing that the pleader is entitled to relief. F.R.Civ.P. 8(a)(2). If the pleading meets the requirements of Rule 8 and fairly notifies the

opposing party of the nature of the claim, a motion for a more definite statement will not be granted. 2 A Moore's *Federal Practice* ¶ 12.18[1], at 2389 (2d ed. 1979). "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other conditions of mind of a person may be averred generally." F.R. Civ.P. 9(b).

After examining the third-party complaint, the court finds that in paragraph one of the third-party complaint, Mr. Rogers incorporates by reference the consolidated amended complaint filed by plaintiffs, which contains a detailed description of the alleged securities fraud scheme. In paragraph three, the Packard group is named as a third-party defendant, and its role in the alleged scheme is specified. Finally, in paragraph four, Mr. Rogers explains that he seeks indemnity/contribution from the Packard group because of its participation in the scheme already described. Considering that Rule 12(e) "is designed to strike at unintelligibility rather than want of detail," [45] the court is compelled to deny third-party defendant's motion for a more definite statement. The third-party complaint is not so vague or ambiguous as to make it unreasonable to require a proper answer. The various pre-trial devices for discovery can be utilized to fill in any possible gaps. See 2A Moore's *Federal Practice* ¶ 8.13, at 8–115 (2d ed. 1979).

[22] Accordingly, the Packard group's motion for a more definite statement is denied.

VII. *THIRD-PARTY DEFENDANT STIX & CO.'S MOTION FOR SUMMARY JUDGMENT/TO DISMISS AGAINST UNION BANK OR A MOTION FOR A PROTECTIVE ORDER.*

Third-party defendant Stix & Co. (hereinafter Stix) is a broker-dealer who, through its manager, Harry Mayfield, is alleged to have been a member of the syndicate which underwrote the subject bonds.[46] As noted, Union Bank was the trustee of the express trusts created by the bond/note indenture and was the party executing the certificate of authentication.

On May 14, 1979, Union Bank filed an amended third-party complaint seeking indemnity and contribution from Stix. This matter is before the court on defendant Stix' motion for summary judgment/to dismiss, or in the alternative, motion for a protective order.

A. *MOTION FOR SUMMARY JUDGMENT/TO DISMISS*

Stix' motion is based essentially on two arguments: [47] (1) Union Bank is not entitled to indemnity for any of the claims alleged against Stix in the third-party complaint; and (2) Union Bank is not entitled to contribution for any of the claims alleged.

1. *Indemnity*

Union Bank is alleged to have violated §§ 17(a) and 12(2) of the Securities Act of 1933, § 10(b) of the Securities Exchange Act of 1934, and Rule 10b–5, as well as a variety of state claims. The issue of federal indemnity was examined in detail in Section (VI)(A)(1)(a) of this order, and the court's analysis need not be repeated here.

As for the state claims, defendant Union Bank is alleged to have violated, among others, Cal.Corp.Code (West) §§ 25401 and 25501, provisions which prohibit negligent misrepresentation. *Bowden v. Robinson*, 67 Cal.App.3d 705, 715, 136 Cal.Rptr. 871 (1977). Defendant Union Bank seeks indemnity for this provision and others. The issue of state law indemnity was examined

45. 2A Moore's Federal Practice ¶ 12.18[1], at 2389 (2d ed. 1979).

46. See section (I)(C)(2) for the discussion about underwriters.

47. Stix also claims that it did not sell any securities to the plaintiffs in this action so it did not owe a duty to them and therefore could not be held liable. Contrary to what Stix asserts, this matter was certified as a class action by order of this court on June 9, 1978.

in detail in Section (VI)(A)(1)(b) of this order, and the court's analysis need not be re-explored.

2. *Contribution*

In Section (VI)(A)(2)(a) & (b) of this Order, this court examined the issue of contribution in securities fraud cases, so it is not necessary to re-explore that area. One point raised here, however, that was not raised in the Packard group's motion is Stix' assertion that since Union Bank and Stix served different functions entailing different duties, then they cannot be liable in tort to the same person for the same harm.

In support of its contentions, Stix cites *Wassel v. Eglowsky*, 399 F.Supp. 1330, 1367 (D.Md.1975), *aff'd*, 542 F.2d 1235 (4th Cir. 1976), which said: "The necessary predicate for a contribution recovery is that the party it is recovered from be a 'joint tortfeasor', i. e., that he be liable in tort to the same person for the same harm."

The court finds *Wassel* inapposite and contribution proper in the circumstances presented here. The court in *Wassel* refused to permit contribution from Central Trust Bank, an establishment which had served as a stock transfer agent (*id.* at 1336–37) because the court could find no statute or case imposing liability on a transfer agent in the same position as Central Trust (*id.* at 1367). Also, plaintiff in *Wassel* was a person with whom Central Trust had never dealt or had contact. Finally, it neither knew nor had reason to know of any improprieties in the re-issuance of the subject shares. *Id.* at 1367 & 1368.

[23] The record presented to the court does not permit it to conclude that third-party defendant Stix is in the same position as Central Trust in *Wassel*. Stix, unlike Central Trust, completed transactions with members of the plaintiff class. Also, as a member of the underwriting syndicate, Stix may be held liable for violations of federal securities laws. Finally, both Union Bank and Stix are charged with being active and knowing participants in a securities fraud. The court does not express an opinion about Stix' culpability, but it must point out the differences between the situation in *Wassel* and the one present here. If both Union Bank and Stix are found liable as participants in the allegedly fraudulent scheme, then they will be "liable in tort to the same person for the same harm." Since the court is not in a position to say whether or not the parties are liable, third party defendant's motion for summary judgment/to dismiss is denied. F.R.Civ.P. 56(c); *Powell v. Southwestern Bell Tel. Co.*, 494 F.2d 485, 489 (5th Cir. 1974).

B. *MOTION FOR A PROTECTIVE ORDER*

Stix also seeks a protective order providing that depositions taken prior to the occurrence of the later of (1) the certificate of the suit as a class action, or (2) the ruling on the motion of third-party defendant Stix for summary judgment will not be used against Stix, and further, that if Stix is not released as a party to the action, it shall have the right to re-depose any party which has already been deposed. Stix cites no authority for its motion and the court does not find its factual argument persuasive. Accordingly, Stix' motion for a protective order is denied.

VIII. *THIRD PARTY DEFENDANT STIX & CO'S MOTION FOR SUMMARY JUDGMENT/TO DISMISS AGAINST HAROLD E. ROGERS.*

As in its motion against Union Bank, Stix maintains that third-party plaintiff Rogers is not entitled to indemnification or contribution for any of the claims alleged in the third-party complaint. Since these issues have been discussed in earlier portions of the order, the court need not review them again. Accordingly, this motion is denied.

IX. *THIRD-PARTY DEFENDANTS PACKARDS' AND PRAHM'S MOTION TO DISMISS THIRD-PARTY COMPLAINT OF DEFENDANT URBAN J. SCHREINER OR MOTION FOR A MORE DEFINITE STATEMENT.*

As noted, the Packards and Prahm were owners of Quimby Island and allegedly par-

ticipated in the sale of Quimby Island to the Quimby Island Reclamation District. Defendant and third-party plaintiff Urban Schreiner was the attorney who issued the bond-note opinion letters. Mr. Schreiner filed his answer to plaintiffs' original complaint on June 30, 1977. He subsequently filed an answer to plaintiffs' consolidated amended complaint on February 16, 1979. Ten days later, defendant Schreiner filed a third-party complaint without leave of court.

A. *MOTION TO DISMISS*

The Packard group moves to dismiss defendant Schreiner's action because it claims that: (1) contribution is not recoverable; (2) the third-party complaint was filed improperly according to F.R.Civ.P. 14, and (3) they will be unduly prejudiced if the complaint is permitted to stand.

The court has already addressed the contribution issue in Section (VI)(A)(2) of this order and found that contribution is permissible under both federal and state law. Accordingly, there is no merit to third-party defendants' first ground for denial of the third-party complaint.

Nor can the court accept the reasoning for the Packard group's second ground for their motion to dismiss. Under Rule 14, a third party may be brought into an action and the party impleading "need not obtain leave to make the service if he files the third-party complaint not later than 10 days after he serves his original answer." Whether Mr. Schreiner needed leave of court before filing his third-party complaint on February 26, 1979, depends on the interpretation of the phrase "original answer."

[24] "An amended pleading that is complete in itself and makes no reference to nor adopts any portion of the prior pleading supersedes the latter." 3 Moore's *Federal Practice* ¶ 15.08[7], at 15–127 (2d ed. 1979). *Accord, Lubin v. Chicago Title & Trust Co.*, 260 F.2d 411, 413 (7th Cir. 1958). Under this interpretation, the second complaint becomes the original complaint. It necessarily follows that an answer to such a complaint is the original answer. The court finds that the term "original answer" refers to the first answer to the complaint that is in effect at that time, as opposed to an amended or supplemental answer to that complaint. This view not only comports with logic, but it is also in agreement with the policy objective of Rule 14(a) which is to give the defendant an incentive to implead the third party seasonably.[46] 3 Moore's *Federal Practice* ¶ 14.05[2], at 14–197 (2d ed. 1979).

Finally, the court is not persuaded by the Packard group's final argument concerning prejudice. The compromise reached by the bankrupt district and third-party defendants had nothing to do with Mr. Schreiner and had no impact on his rights to contribution. As before, the court believes that any possible prejudice will be outweighed by the utility of having all aspects of this litigation decided in one proceeding.

[25] Accordingly, the Packard group's motion to dismiss is denied.

B. *MOTION FOR A MORE DEFINITE STATEMENT*

In his third-party complaint filed on February 26, 1979, defendant Schreiner incorporates the consolidated amended complaint by reference. In paragraph three, he specifies the role the Packard group played in the alleged scheme. Upon examination, the court does not believe the third-party complaint is so vague and ambiguous that it would be unreasonable to require an answer.

46. The court is reinforced in its decision to deny third-party defendant's motion to dismiss on the basis of Rule 14 because of *Hensley v. United States*, 45 F.R.D. 352, 353 (D.Mont. 1968), in which the court stated "that leave of court must be obtained . not for protection of the third-party defendant, but for the protection of the parties to the principal action who have a legitimate concern in the orderly and timely disposition of their litigation. Since the timeliness of the procedure is of no concern to the third party when he is brought in, he may not challenge the jurisdiction of the court." The ten-day limitation of Rule 14 is thus for the protection of the parties in the action and since none of them have complained, the court feels that impleader is proper.

[26] Accordingly, the Packard group's motion for a more definite statement is denied.

X. *THIRD-PARTY DEFENDANTS PACKARDS' AND PHRAHM'S MOTION TO VACATE THE ORDER ALLOWING UNION BANK TO FILE A THIRD-PARTY COMPLAINT, OR MOTION TO DISMISS THE AMENDED THIRD-PARTY COMPLAINT, OR MOTION FOR A MORE DEFINITE STATEMENT AS TO COUNTS 18, 19, 20, and 25.*

On April 20, 1979, this court issued an order granting Union Bank's motion to file a third-party complaint. Union Bank filed an amended third-party complaint on May 14, 1979. This matter is before the court on the Packard group's motion to vacate the earlier order permitting the third-party complaint, or to dismiss, or motion for a more definite statement.

A. *MOTION TO VACATE OR DISMISS*

On April 20, 1979, the court held hearings before issuing its order granting leave to file the third-party complaint. The former counsel for the Packard group was present at the hearing, but said nothing in opposition to Union Bank's motion. After the motion was granted, he requested the court to direct Union Bank to provide him with free copies of the discovery that had thus far taken place in the action. He also agreed to accept service of the first complaint on the Packard group's behalf. As will be seen, the court finds no reason to reconsider its decision to permit Union Bank's third-party complaint and accordingly denies the Packard group's motion to vacate the earlier order.

The Packard group moves to dismiss the amended third-party complaint on several grounds: (1) Union Bank fails to state a claim for contribution; (2) Union Bank fails to state a claim for indemnity; (3) Union Bank fails to state a claim for constructive trust; and (4) the Packard group will be unduly prejudiced if the motion is granted.

1. *Indemnity*

This issue has been raised throughout these motions so that no further elaboration is necessary here.

2. *Contribution*

As with the indemnity issue, the court has examined this question in detail and concluded that contribution is proper. Accordingly, the Packard group's motion to dismiss as to the contribution claim is denied.

3. *Constructive Trust*

In count twenty-five of the amended third-party complaint, Union Bank requests:

> 4. That this court impress a constructive trust upon any monies re-received by Oxford Life Insurance Company and the Packards and Prahm for monies received directly or indirectly out of the proceeds of the sale of the securities which constitute the subject matter of plaintiffs' consolidated amended complaint.

The Packard group opposes Union Bank's claim for constructive trust for five reasons: (1) it is not appropriate under F.R. Civ.P. 14; (2) Union Bank comes to equity with "unclean hands"; (3) Union Bank lacks standing to assert a claim for constructive trust; (4) the District released the Packard group from all claims; and (5) Union Bank is not a real party in interest.

"A constructive trust is a remedy used by a court of equity to compel a person who has property to which he is not justly entitled to transfer it to the person entitled thereto. The trust is passive, the only duty being to convey the property." 7 Witkin, *Summary of California Law* § 131, at 5487 (8th ed. 1978.)

Neither side submits much legal authority for its respective position. On the surface, it appears that a constructive trust may be merely indemnity under another cover. In any event, a constructive trust is a remedy used by a court of equity, so the point need not be decided now. The matter

can be examined after trial when the record is more complete. The issue may never present itself.

4. *Prejudice*

The issue of prejudice has been raised by the Packard group previously and the court has examined it in sections (VI)(A)(3) and (IX)(A) of this order. After examining the moving papers, the court feels that defendant Union Bank has proceeded diligently and expeditiously in prosecuting its third-party action, and the court feels that any prejudice is outweighed by the utility of having all aspects of this litigation decided in one proceeding.

[27] Accordingly, the Packard group's motion to dismiss is denied.

B. *MOTION FOR A MORE DEFINITE STATEMENT*

[28] The court has examined the amended third-party complaint filed by Union Bank and finds that in count one, paragraph three, Union Bank incorporates by reference the consolidated amended complaint. In count eighteen, Union Bank specifies the position of the Packard group in the alleged scheme and describes the acts for which it seeks contribution. A similar provision is incorporated in counts nineteen, twenty, and twenty-five, where Union Bank requests indemnity, partial indemnity, and the application of a constructive trust, respectively. The court believes that the third-party complaint is not so vague and ambiguous as to make it unreasonable to require a proper answer. Accordingly, the Packard group's motion for a more definite statement is denied.

XI. *DEFENDANT MUNICICORP OF CALIFORNIA, KENNETH W. ROGERS, AND ALAN M. STAHL'S MOTION FOR LEAVE TO FILE A THIRD-PARTY COMPLAINT.*

In the consolidated amended complaint, plaintiffs maintain that MuniciCorp is a registered broker/dealer who served as an underwriter of both the bonds and notes. Defendant Rogers was president and largest shareholder of MuniciCorp while defendant Stahl was executive vice-president and a shareholder of MuniciCorp (the three will hereinafter be referred to as the MuniciCorp group.) They are alleged to have been involved in the fraudulent scheme which is the subject of this lawsuit.

On June 20, 1977, the MuniciCorp group answered plaintiffs' initial complaint. They answered plaintiffs' amended complaint on January 18, 1978. As noted, the amended consolidated complaint was filed in November of that year, and the MuniciCorp group filed its answer and the accompanying motion for leave to file the third-party complaint. In light of Section (IX)(A) of this order in which the court concluded that an answer to the consolidated amended complaint was an "original answer" within the meaning of Rule 13(a), the MuniciCorp group may file the third-party complaint without leave of court. Moreover, the court sees nothing dilatory in the MuniciCorp group's action and believes that any possible potential prejudice that might be suffered is outweighed by the utility of having all aspects of this litigation decided in one proceeding.[49]

Besides claiming that the MuniciCorp group unfairly delayed in bringing the third-party action, the Packard group maintains that the MuniciCorp group improperly requests the imposition of a constructive trust. The court has addressed this issue earlier and concluded that it should be taken up at a later time.

[29] Accordingly, MuniciCorp's motion to file a third-party complaint is granted.

In accordance with the foregoing, it is hereby ordered as follows:

(1) Defendant Union Bank's Motion for Summary Judgment against Plaintiffs is denied;

49. The third-party complaint filed by the MuniciCorp group is substantially the same as those filed by defendants Union Bank, Harold E. Rogers, Jr., and Urban J. Schreiner. Two new parties, J. A. Sanford & Co., which was the principal underwriter of the bonds and W. Charles Jensen, its former head, are added.

(2) Plaintiff Bondholders' Motion for Summary Judgment against defendant Union Bank is denied;

(3) Plaintiff Noteholders' Motion for Summary Judgment against defendant Union Bank is denied;

(4) Defendant Gibralco, Inc. and Gunther's Motion to Dismiss/For Summary Judgment against Plaintiffs is granted as to Securities Act of 1933 § 12(2), 15 U.S.C. § 77*l*(2);

(5) Third-Party Defendant Wilkins' Motion to Dismiss against Third-Party Plaintiff Union Bank is denied, subject to reconsideration after further briefing;

(6) Third-Party Defendants Packards' and Prahm's Motion to Dismiss Third-Party Complaint of Defendant Harold E. Rogers or Motion for a More Definite Statement is denied;

(7) Third-Party Defendant' Stix & Co's Motion for Summary Judgment/To Dismiss against Union Bank or a Motion for a Protective Order is denied;

(8) Third-Party Defendant Stix & Co's Motion for Summary Judgment/To Dismiss against Harold E. Rogers is denied;

(9) Third-Party Defendants Packards' and Prahm's Motion to Dismiss Third-Party Complaint of Defendant Urban J. Schreiner or Motion for a More Definite Statement is denied;

(10) Third-Party Defendants Packards' and Prahm's Motion to Vacate the Order Allowing Union Bank to File a Third-Party Complaint, or Motion to Dismiss the Amended Third-Party Complaint, or Motion for a More Definite Statement as to Counts 18, 19, 20, and 25, is denied;

(11) Defendant MuniciCorp of California, Kenneth W. Rogers, and Alan M. Stahl's Motion for Leave to File a Third-Party Complaint is granted.

[¶ 96,826] Baron, et al. v. Commercial & Industrial Bank of Memphis, et al.

United States District Court, Southern District of New York. 75 Civ. 1274 (LBS). April 11, 1979. Amended on April 18, 1979. Opinion in full text.

Securities Act—Exemptions—Industrial Development Bonds—Summary Judgment.—The question of whether bonds were issued by a "political subdivision" or were tax-exempt industrial bonds, within the coverage of the exemption provided by Section 3(a)(2) of the Securities Act, could not be determined on a motion for summary judgment. It was for a jury to determine the tax status of the bonds.

See ¶2021, "Securities Act—Exemptions" division, Volume 1.

Securities Act—Definition of Prospectus—Opinion Letter—Bonds—Subsequent Mailing.—A bond opinion, printed on every bond certificate mailed to purchasers after the sale was completed, constituted a "prospectus" within the meaning of Section 12(2) of the Securities Act.

See ¶1451, "Securities Act—Definitions" division, and ¶4735, "Securities Act—Liabilities" division, Volume 1.

Securities Act—Antifraud—Private Right of Action.—Until the Supreme Court addresses the issue or the Second Circuit reverses itself, the district court will adhere to the rule in the Circuit that Section 17(a) of the Securities Act provides a private right of action.

See ¶4815, "Securities Act—Liabilities" division, Volume 1.

Exchange Act—Antifraud—Cumulative Remedies.—The court rejected the argument that a private remedy cannot be implied under Section 10(b) of the Exchange Act where an express remedy is available under Section 12 of the Securities Act. The remedies provided by Section 10(b) are cumulative and not exclusive.

See ¶22,721 and 22,725, "Exchange Act—Manipulations; National Market System" division, Volume 2.

Antifraud—Scienter—Bond Counsel—Summary Judgment.—Summary judgment was inappropriate on the question of whether a law firm issuing a bond opinion violated the antifraud provisions. On the evidence presented, the court could not definitively resolve whether the firm knew or should have known of the alleged fraudulent scheme.

See ¶4815, "Securities Act—Liabilities" division, Volume 1; and ¶22,721 and 22,725, "Exchange Act—Manipulations; National Market System" division, Volume 2.

Antifraud—Class Action—Adequacy of Representative—Honesty.—The failure of class representatives to disclose the circumstances surrounding their purchase of bonds in their initial affidavit did not warrant class decertification. This appeared to be a situation where plaintiffs unschooled in securities law litigation and represented by inadequate counsel at the time, failed to notice that their affidavit omitted the facts surrounding the receipt of a prospectus. Nor could class counsel be deemed inadequate because it chose a litigation strategy arguing that the second bonds were not parity bonds.

See ¶22,721 and 22,725, "Exchange Act—Manipulations, National Market System" division, Volume 2.

R. Alan Stotsenburg, New York, N.Y., for plaintiffs.

James J. Farley, Scottsdale, Arizona, for intervenor-plaintiffs.

White & Case, New York, N.Y., for defendant Commercial & Industrial Bank of Memphis.

Rogers, Hoge & Hills, New York, N.Y., for defendants Linde Thomson and Kohn.

SAND, District Judge: This Court, in an opinion filed on August 22, 1978,[1] determined that this securities action could be maintained as a class action and certified two classes: purchasers of bonds issued by the Buffalo Valley Gas Authority ("Authority") in July, 1973, represented by Joseph and Hazel Day with James F. Farley as counsel, and purchasers of bonds issued by the Authority in December, 1973, represented by Jerome Shenker with R. Alan Stotsenburg as counsel.

Plaintiff Shenker on behalf of the second class of bond purchasers now moves for summary judgment against defendants:[2] Linde Thomson Van Dyke Fairchild & Langworthy ("Linde Thomson") and Herbert M. Kohn

---

[1] Hereafter, this opinion is referred to as the certification opinion.

[2] Also named as defendants are the bank which acted as mortgagee and bond trustee, the Authority and its trustees; several individuals involved in the creation of the Authority and the construction of the facilities and certain underwriters involved in the issuance of the bonds. Since this action was filed, the Authority's receiver has been granted leave to intervene as a defendant.

("Kohn").[3] Defendants Linde Thomson and Kohn move to dismiss the complaint for failure to state a claim upon which relief can be granted pursuant to F.R.Civ. P. 12(b)(6) or, alternatively, for summary judgment. Finally, defendants Linde Thomson and Kohn move to decertify this action as a class action or, alternatively to decertify Joseph Day, Hazel Day and Jerome Shenker as class representatives and R. Alan Stotsenburg as class counsel.[4]

The underlying facts and procedural history are set forth in the certification opinion and will not be repeated here. Since that opinion was filed, plaintiffs moved to amend their complaint to assert a claim under section 12(2) of the Securities Act of 1933, 15 U.S.C. §17(1) and to correct an arithmetic error in the *ad damnum* clause. Leave to amend was granted on October 18, 1978.

Defendants' Motion to Dismiss

Defendants Linde Thomson and Kohn contend that the complaint must be dismissed because, as a matter of law, it fails to state a claim under §12(2) of the Securities Act of 1933, 15 U.S.C. §17(1), §17(a) of the Securities Act of 1933, §77(q), and §10 of the Securities Act of 1934, 15 U.S.C. §78(j).

Section 12(2) claim:

Defendants contend that the Authority bonds are exempt from coverage under §12(2) of the 1933 Securities Act because they are either bonds issued by a "political subdivision" or tax-exempt industrial bonds.[5] Plaintiff does not dispute that such categories of securities are exempt from §12(2) coverage, he argues, however, that the Authority bonds are non-exempt industrial bonds and thus within the ambit of §12(2).

On the papers before us, we cannot classify these bonds as either bonds issued by a "political subdivision" or tax-exempt industrial bonds. The record indicates that the Authority was created under the terms of an Oklahoma statute entitled "Trusts for the Furtherance of Public Functions."[6] Although we agree with the defendants that bonds issued by other Oklahoma trusts pursuant to this statute have been found by the Internal Revenue Service to be bonds "issued by a political subdivision",[7] we find that this ruling is not dispositive of the case before us. Initially, we note that the ruling cited by defendants is explicitly limited to the facts of the Oklahoma County Utility Services Authority. Moreover, the Supreme Court of Oklahoma had previously sustained the validity of that trust and the acceptance of the beneficial interest by the Board of County Commissioners of Oklahoma County. Thus, the Internal Revenue Service could conclude as to that trust that "income will never accrue to the benefit of any person, firm, or corporation."[8] Such a conclusion cannot be drawn in the instant action. Plaintiff disputes that the bonds were *validly* issued on behalf of the City of Clayton.[9]

Similarly, we cannot conclude on the facts before us that the bonds are tax exempt industrial bonds.[10] In order to qualify for the tax exemption, substantially all of the proceeds of the bond must be used to provide facilities for

---

[3]Plaintiffs for both bond classes also move for an order pursuant to F.R.Civ.P. 23 directing that notice be given to those class members whose identity has been ascertained by publication in the *Arizona Republic* and permitting plaintiffs to employ a locator service with respect to envelopes containing class notice which have been returned by the U.S. Postal Service marked "undeliverable". At oral argument of these motions on March 14, 1979, the parties advised the Court that they had reached an agreement among themselves concerning the question of notice and we will deem this motion to be withdrawn.

[4]Defendant Commercial & Industrial Bank ("C & I Bank") also submitted an affidavit and memorandum of law in support of this motion.

[5]Section 12(2) does not apply to those categories of securities listed in §3(a)(2). That section provides in pertinent part

"Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities.

***

(2) *Any security* issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or *by any political subdivision of a State or Territory, or by any public instrumentality of one or more States or Territories*, or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States, ... or *any security which is an industrial development bond (as defined in section 103(c)(2) of the Internal Revenue Code of 1954) the interest on which is excludable from gross income under section 103(a)(1) of such Code* if, by reason of the application of paragraph (4) or (6) of section 103(c) of such Code (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security..." (emphasis added).

[6]Oklahoma statutes §§176-180 (Supp. 1970).

[7]Rev. Rul. 57-151, 1957-1 C.B. 64.

[8]*Id.* at 65.

[9]Plaintiff also relies on Revenue Ruling 63-20, 1963-1, 24. This ruling, however, covers "obligations issued by a nonprofit corporation formed under the general nonprofit corporation law of a state." There is no contention here that the Authority is a nonprofit corporation formed under the general nonprofit corporation law of Oklahoma.

[10]If the bonds are not bonds of a political subdivision, the parties agree that they are "industrial development bonds" pursuant to Internal Revenue Code §103(b)(2). The parties dispute, however, their tax status.

the local furnishing of gas ("90% rule").[11] Because the Authority already had a supply contract with Wyoming Oil & Gas Company ("Wyoming") which enabled it to obtain all the gas it needed from Wyoming,[12] plaintiff argues that the $400,000 expended by the Authority to purchase the well from Wyoming did not qualify as an acquisition expense and thus the 90% rule was not met.[13]

In support of this argument, plaintiff cites a letter of the Internal Revenue Commissioner Alexander to the Securities and Exchange Commission, dated July 27, 1976, in which the Internal Revenue Service set forth the rule that certain leaseback arrangements do not qualify for tax-exempt treatment:

> "Finally, there are certain other costs which, under the facts submitted, may be considered nonqualifying. Assume a company already owns some equipment, sells the equipment back to the issuer, and then enters into a lease-purchase arrangement similar to that in Rev. Rul. 68-590, 1968-2 C.B. 66. We would consider the transaction to be a secured loan and not an acquisition under section 103(c)(6)(A) of the Code, and the total cost would not qualify."

Defendants do not dispute that the Authority paid $400,000 for the well. They argue, however, that the well acquired by the Authority was unquestionably a depreciable property within the guidelines outlined in Commissioner Alexander's letter and the leaseback arrangement found objectionable by Commissioner Alexander does not apply to the Authority's purchase.

We need not resolve this issue now. In the letter referred to above Commissioner Alexander stated that only bona-fide and reasonable costs of acquisition of land or depreciable property qualify.[14] It is for a jury to decide whether purchase of a gas well for $400,000 is a bona-fide and reasonable cost considering that Wyoming purchased the well for $5,000 and that the Authority had a supply contract with Wyoming which granted them the right to use the gas.

Besides arguing that the bonds do not come within the purview of §12(2), defendants argue that the statute is inapplicable to the facts of this action because their opinion letter was not a "prospectus" and, even assuming that it was a prospectus, the sales to plaintiffs were not made by "means of a prospectus", *i.e.*, the bond opinion was sent to plaintiffs *after* the bond sales had been completed.

We disagree. Section 2(10) broadly defines "prospectus" to include any letter or communication which offers any security for sale

---

[11] I.R.C. §103(b)(4) provides:

"Certain exempt activities—Paragraph (1) shall not apply to any obligation which is issued as part of an issue substantially all of the proceeds of which are to be used to provide—

(A) residential real property for family units,

(B) sports facilities,

(C) convention or trade show facilities,

(D) airports, docks, wharves, mass commuting facilities, parking facilities, or storage or training facilities directly related to any of the foregoing,

(E) sewage or solid waste disposal facilities or facilities for the local furnishing of electrical energy or gas,

(F) air or water pollution control facilities, or

(G) facilities for the furnishing of water for any purpose if—

(i) the water is or will be made available to members of the general public (including electric utility, industrial, agricultural, or commercial users), and

(ii) either the facilities are operated by a governmental unit or the rates for the furnishing or sale of the water have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

For purposes of subparagraph (E), the local furnishing of electric energy from a facility shall include furnishing solely within the area consisting of a city and 1 contiguous county."

The phrase "substantially all of the proceeds" has been interpreted under §1.103-8(a) of the Income Tax Regulations to require that at least ninety percent of the proceeds be expended on the exempt facility.

[12] Neither party submitted a copy of the supply contract between Wyoming and the Authority. For the purposes of this motion, we have assumed that such a contract exists and that it gives the Authority the right to purchase gas.

[13] The Authority received approximately $8,470,000 from the two bond issues. The only disbursement at issue here is the $400,000 acquisition cost of the gas well. The other disbursements from the proceeds of the Authority's bond issues are set forth in Exhibit 5 to the Affidavit of Richard Schulman submitted in support of this motion.

[14] The Commissioner stated: "Thus, an industrial development bond, which otherwise qualifies, will be tax-exempt if at least 90 percent of the bond proceeds is allocable to the bona fide and reasonable costs of acquisition, construction, reconstruction, or improvement of land or depreciable property (qualifying costs), and no more than 10 percent of the bond proceeds is allocable to other costs (nonqualifying costs)." Letter to Commissioner R. M. Hills, dated July 27, 1976, p. 2

or confirms the sale of any security. We also find that the bond opinion, printed on every bond certificate mailed to purchasers after the sale was completed, constitutes a "prospectus" within the meaning of §12(2). In *DeMarco v. Edens*, 390 F.2d 836 (2d Cir. 1968), the Court of Appeals held that stock is sold by means of a prospectus even where the prospectus is mailed subsequent to the consummation of the sale. See also *Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875 (2d Cir. 1943).

Finally, defendants argue that plaintiff's §12(2) claim is time-barred. Section 13 requires that such claims be brought within one year after discovery of the untrue statement or omission.[15]

We agree with the defendants that plaintiff does not allege facts sufficient to ascertain whether the §12(2) claim was filed within one year after the alleged untrue statements or omissions of material facts should have been discovered as required by §13. See *Ingenito v. Bermec Corp.*, 376 F.Supp. 1154, 1173 (S.D.N.Y. 1974). Accordingly, plaintiff's §12(2) claim will be dismissed unless an amended complaint setting forth factual allegations demonstrating compliance with the one-year time limitation is filed within fifteen days of the entry of this order.[16]

Section 17(a)

Defendants argue that §17(a) does not create a federal right of action in favor of private parties. In making this argument defendants must overcome the clear language of *Kirshner v. United States*, [1978] CCH Fed. Sec. L. Rep. ¶96,617 (2d Cir. 1978).[17]

Rather than distinguishing this case on its facts, defendants argue that the *Kirshner* decision ignores the legislative history of the securities laws and relies heavily on *Daniel v. International Brotherhood of Teamsters*, 561 F.2d 1223 (7th Cir. 1977), a decision which has been reversed by the Supreme Court.[18] Based on these factors, defendants hypothesize that the Second Circuit might withdraw its opinion in *Kirshner sua sponte* or reverse itself on a motion for reconsideration.

We find these arguments unpersuasive. Until the Supreme Court addresses the issue or the Second Circuit reverses itself, we adhere to the rule in this circuit that §17(a) provides a private right of action.

Section 10b-5

Finally, defendants suggest that a private right of action should not be implied under §10(b) of the 1934 Act because an express remedy is provided under §12(2) of the 1933 Act. According to defendants, the detailed procedural and substantive requirements with which Congress surrounded actions under §12 of the 1933 Act would be nullified if plaintiffs were permitted to file a §10(b) claim for the same type of conduct proscribed by §12.

Defendants cite no case which holds that a private remedy cannot be implied under §10(b) where an express remedy is available under §12 of the 1933 Act.[19] We find that the law is otherwise. The remedies provided by §10(b) are cumulative and not exclusive. See *Jordan Building Corp. v. Doyle, O'Connor & Co.*, 401 F.2d 47, 51 (7th Cir. 1968).

Plaintiff's Motion for Partial Summary Judgment

Plaintiff Shenker moves on behalf of the second class of bond purchasers for summary judgment against defendants Linde Thomson and Kohn. Plaintiff contends that he is entitled to summary judgment because, as a matter of law, Linde Thomson's second bond opinion was false at the time it was delivered on December 4, 1973:

> "The second opinion specifically stated that the second bonds were a 'first and prior lien on all present and future net revenues' of the Authority and 'on a *parity* [emphasis in original] with the first bonds.' To the contrary, plaintiffs submit, the second bonds were not parity bonds ranking equally with the first bonds. ... Since they were not parity bonds, their lien on the trust estate, if any, would be a junior lien. Junior lien bonds are, of course, a totally different kind of security." Plaintiff's Memorandum of Law, pp. 28-29

[15] Section 13 of the Securities Act of 1933, 15 U.S.C. §77(m) provides in pertinent part:

"No action shall be maintained to enforce any liability created under section 77k or 77l(2) of this title unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the action is to enforce a liability created under section 77l(1) of this title, unless brought within one year after the violation upon which it is based. In no event shall any such action be brought to enforce a liability created under section 77k or 77l(1) of this title more than three years after the security was bona fide offered to the public, or under section 77l(2) of this title more than three years after the sale."

[16] We hold that the amendment of the complaint to assert a §12(2) cause of action relates back to the filing of the original complaint (March 14, 1975). See F.R.Civ.P. 15 (c).

[17] In that case, the Second Circuit stated: "The Court below also held that Kirshner has no claims under §17a of the 1933 Act, 15 U.S.C. §77q, because no private cause of action is recognized under this section. We disagree with this conclusion." [1978] CCH Fed. Sec. L. Rep. ¶96,617 at 94,672.

[18] 47 U.S.L.W. 4135 (January 16, 1979).

[19] Defendants cite *Rosenberg v. Globe Aircraft Corp.*, 80 F.Supp. 123 (E.D. Pa. 1948) in support of their argument. In that case, however, the court never reached the issue whether the activities complained of constituted violations of §10(b).

In his reply brief, plaintiff initially maintained that under the principles of *SEC v. Research Automation Corp.*, 585 F.2d 31 (2d Cir. 1978), he is entitled to summary judgment because defendants have failed to controvert the facts put forward as undisputed. *Research Automation* does not mandate summary judgment here. In that case, defendants failed to submit any support, other than an affidavit which "totally failed to contradict [the charges] with any specificity" in opposition to the motion for summary judgment. *SEC v. Research Automation Corp.*, 585 F.2d at 34. Here, defendants filed a lengthy Rule 9(g) statement, supported by two affidavits with nineteen exhibits attached.

Defendants, on the other hand, argue at the outset that summary judgment must be denied because the pleadings contain no allegation:

> "suggesting that the December 1973 bonds were junior and subordinate to the July 1973 bonds; that the rights of the December 1973 bondholders were in any way compromised by the amendment to the bond indenture; that Linde Thomson or Kohn would be called upon to account for the purportedly junior lien status of the December 1973 bonds; or that Linde Thomson's December 4, 1973 bond counsel opinion was incorrect to the extent that it concluded the December 1973 bonds were on a parity with those issued in July 1973." Defendants Linde Thomson and Kohn's Memorandum at 21.

Having reviewed the three complaints filed in this action, we find that defendants had adequate notice that plaintiffs were challenging the validity of the amendments to the trust indenture as well as the content of the second bond opinion. See paragraphs 26, 29, 33 and 34 of the amended complaint. Although we conclude that plaintiff's motion for summary judgment may be entertained in its present form, we find that it raises factual issues which must await trial.

Section 12(2) claim

Plaintiff's motion for summary judgment on its §12(2) claim fails for the same reason that defendants' motion to dismiss this claim fails: we cannot determine, on the undisputed facts before us, whether these bonds fall within §12(2), or, as defendants argue, they are exempt under §3(a). See discussion on page 3 *supra*. Because we cannot determine at this juncture whether plaintiff has a valid §12(2) claim, we decline to reach the other issues raised in plaintiff's motion for summary judgment on its §12 claim.

Section 17(a) and section 10(b) claims

Plaintiff also claims that the second class of bond purchasers is entitled to summary judgment under §17(a) of the 1933 Act and §10(b) of the 1934 Act.[30] The essential elements of a §10 claim for relief include: (1) the existence of fraudulent conduct which was "in the offer or sale" of a security under §17(a) or "in connection with the purchase or sale" of a security under §10(b); (2) material misrepresentations or omissions by the defendants of material facts; (3) an intent to deceive, manipulate, or defraud plaintiff [scienter]; (4) reliance by plaintiff upon defendants' misrepresentations, and (5) damages suffered by plaintiff as a result of his reliance or due to the fraudulent scheme. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 378-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

Although defendants argue that plaintiff has failed to establish any of these elements,[31] they focus their opposition to summary judgment on the scienter requirement. According to de-

[30]Both sides group the §17(a) and §10(b) claims together and limit their discussion to §10(b). Defendants explicitly state that §17(a) differs from §10(b) only in that §17(a) prohibits fraudulent conduct in the offer or sale of any securities whereas §10(b) prohibits fraud in connection with the purchase or sale of any security. For the purposes of this discussion, defendants state that this distinction is irrelevant. There is, however, some indication that the element of scienter may not be required in all §17 claims. See *Mawod & Co. v. SEC*, [Current] CCH Fed. Sec. L. Rep. ¶96,733 (10th Cir. 1979); but see *Sanders v John Nuveen & Co.*, 554 F.2d 790, 790 (7th Cir. 1977) ["In the absence of scienter, judgment for plaintiff cannot be sustained under §17(a)..."]; *Melik v Universal Resources Corp.*, 425 F.Supp. 380 (S.D. Cal. 1976). The Second Circuit has ruled that there is no requirement of scienter in proceedings under §17(a) of the 1933 Act where an injunction is sought. *SEC v. Coven*, 581 F.2d 1020 (2d Cir. 1978).

This Court, however, need not decide the scienter question on this motion. Even if we assume that the "reckless" standard applies to §17(a) claims, plaintiffs have not shown that defendants' conduct constituted recklessness as a matter of law. See page 11, *infra*.

[31]Thus, defendants argue that plaintiff has not proved that the bond opinion of Linde Thomson was false as a matter of law. Plaintiff, on the other hand, claims that the bond opinion was false because the second bonds were issued pursuant to an invalid trust amendment. We agree with defendants that the validity of the trust amendment is an issue which cannot be determined on this summary judgment motion.

fendants, scienter requires a mental state embracing intent to deceive, manipulate or defraud. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). The record, defendants argue, is devoid of any showing of intent.

Plaintiff does not vigorously contend that they have established the *Hochfelder* standard of scienter.[22] Rather, he argues that reckless behavior is sufficient for liability under § 10(b).

"[D]efendants' actions here clearly constitute the kind of recklessness that is equivalent to willful fraud. SEC v. Texas Gulf Sulphur Co., 401 F.2d at 868 (concurring opinion) and which also satisfies the scienter requirement. Roth v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44-47 (2d Cir. 1978); Sundstrand Corp. v. Sun Corp., 553 F.2d 1033, 1040-44 (7th Cir.), cert. denied, 98 S. Ct. 225 (1978); McLean v. Alexander, 420 F.Supp. at 1080-81." Plaintiff's Memorandum of Law at 52-53.

We agree with plaintiff that the Second Circuit has held that, under certain circumstances, reckless disregard of the truth will satisfy the scienter requirement in a private civil action for damages. See *Roth v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44-47 (2d Cir. 1978), *cert. denied*, 47 U.S.L.W. 3391 (December 5, 1978). This circuit, however, has left open the question whether the "reckless disregard of the truth" standard applies to situations where the defendants are not fiduciaries. For purposes of this motion, however, we need not determine whether recklessness suffices here for this Court finds that, even if we apply a recklessness standard, summary judgment is inappropriate.

The Second Circuit defined recklessness:

"Reckless conduct is, at the least, conduct which is highly unreasonable and which represents 'an extreme departure from the standards of ordinary care . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *Roth v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 at 47 (2d Cir 1978) [citations omitted.].

On the evidence before us, we cannot definitively resolve the question whether Linde Thomson or Kohn knew or should have known of the alleged fraudulent scheme. We cannot find as a matter of law that there is anything in the request to draft an amendment to the original bond indenture which would have put the firm on notice of a fraudulent scheme. Similarly, we cannot conclude as a matter of law that it was unreasonable for Linde Thomson to assume that the Oklahoma attorney would timely file the indenture or to rely on the engineer's calculation of the debt reserves.

Motion to Decertify the Class

Relying on the provisional nature of the class certification, defendants argue that this Court should rescind the class certification because the plaintiffs did not rely on a uniform representation in purchasing Authority bonds. Alternatively, defendants ask that this Court decertify Joseph Day, Hazel Day, and Jerome Shenker as class representatives and R. Alan Stotsenberg as class counsel.

Admittedly, the designation of the class representatives and class counsel was provisional. However, this Court stated in its certification opinion that the class issue would be reexamined only if there were changed circumstances.[23] Defendant's' argument that this action should not continue as a class action because putative class members bought their securities on the basis of oral communications was briefed extensively in the plethora of papers filed in opposition to the original class motion.[24] Thus, at the time this Court certified this action as a class action, we were fully apprised of the individual reliance issue. Nevertheless, we held that:

"If proof of reliance is required at trial, separate hearings can be held to determine whether individual class members in fact relied on defendants' circulars. This procedure was explicitly approved by the Second Circuit in Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968), cert. denied sub. nom. Troster Singer & Co. v. Green, 395 U.S. 977 (1969)." Certification opinion at 6-7.

We adhere to that ruling.

The issues raised by Commercial and Industrial Bank merit closer scrutiny. According to C & I Bank, the conflicting sworn testimony of the Days raise questions as to their credibility and fitness as class representatives:

"In their recent answers to interrogatories . . and in recent sworn deposition testimony the Days have made statements regarding

---

[22] In support of the contention that Linde Thomson and Kohn acted with the requisite scienter, plaintiff cites two cases: *Lanza v. Drexel & Co.*, 478 F.2d 1277 (2d Cir. 1973) and *McLean v. Alexander*, 420 F.Supp. 1057 (D. Del. 1976). Neither of these cases, however, involved summary judgment.

[23] Certification opinion at 11.

[24] See especially note 6 of our certification opinion.

the facts surrounding their purchase of Buffalo Valley Gas Authority bonds which conflict totally with their previous sworn statements and with statements submitted to the Court on behalf of their attorneys. In addition, Mr. Day's sworn deposition testimony regarding the circumstances of the purchase of the Buffalo Valley bonds is demonstrably incorrect. In particular, at different times, the Days have said both that they did not and that they did read an offering circular before purchasing Buffalo Valley bonds." C & I Bank Memorandum at 3.

Moreover, C & I Bank contends that the Days are also unqualified to act as class representatives because they are ignorant of this action and also of the underlying facts.

In support of its position, C & I Bank cites *Goldberg* v. *Taylor Wine Co.*, 77 Civ. 1548 (EDNY, class action certification motion filed January 24, 1979). In that case, Judge Sifton denied a motion for class certification because the named plaintiff had misrepresented facts to the Court on a prior occasion.

We do not find that case controlling. Although we do not condone the conduct of the Days in omitting the circumstances surrounding their purchase of Authority bonds in their initial affidavit, we fail to find that this conduct, standing alone, merits decertification. Counsel who represented the Days at the time of the filing of the questionable affidavit has withdrawn.[25] There is no indication that present counsel is inadequate. Further, we find that the Days' affidavit and their deposition testimony are not in conflict. Although the affidavit does not mention a prospectus, the Days testified at their deposition and in response to interrogatories that they received and relied upon a prospectus.

This appears to be an instance where plaintiffs, unschooled in securities law litigation and represented by inadequate counsel, failed to notice that their affidavit omitted the facts surrounding the receipt of the prospectus. This, however, is a far cry from *Goldberg* v. *Taylor Wine Co.*, where the proposed class representative filed an affidavit in opposition to a motion for a change of venue in which he stated that he and his wife had only two thousand to three thousand dollars in cash and would be unable to afford the extra several thousand dollars needed to litigate this action in the Western District of New York. This statement, on which the court relied in denying the motion to transfer, conflicted with a financial statement plaintiff filed five days earlier for a mortgage loan. Based on these discrepancies and plaintiffs' inability to explain them at a hearing, the court concluded that plaintiff tailored his portrayal of his financial status to suit the particular occasion and that there was every reason to believe that plaintiff would continue to do so in the future if permitted to continue as a class representative. Such evidence is lacking here.

Finally, defendants claim that R. Alan Stotsenburg must be decertified as counsel for the second class of bondholders because he advanced the legal argument that the second bonds were not parity bonds. According to defendants:

> "By relinquishing an equal claim as July 1973 bondholders to Buffalo Valley's assets and income, Mr. Shenker and his counsel, Mr. Stotsenburg, have manifested an intent to pursue an [sic] course antagonistic to the substantive rights of December 1973 bondholders, and thus have proven their inability to fairly and adequately represent that class of persons." Defendants' Memorandum in Support of their Motion to Decertify the Lawsuit as a Class Action at 4.

We fail to see why the selection of a litigation strategy makes Mr. Stotsenburg an inadequate class counsel. In the course of complex, multiparty litigation, every counsel must make choices which by their very nature foreclose other arguments. To insist that class counsel, under threat of decertification, keep all options open until trial would only protract already complex and lengthy litigation. This, we decline to do.

Conclusion

Accordingly, defendants' motion to dismiss the §12(2) cause of action is granted unless an amended complaint setting forth factual allegation demonstrating compliance with the one year limitation is filed within fifteen days. In all other respects, defendants' motion to dismiss is denied. Plaintiff's motion for partial summary judgment is denied. Defendants' motion to decertify this action as a class action is denied.

SO ORDERED.

---

[25] At the time of the filing of this affidavit (June 17, 1977), the Days were represented by Richard Berry. Since then, Mr. Berry has been disbarred as a result of actions unrelated to this proceeding.

Exhibit F

Michael P. CRONIN, on his own behalf and on behalf of all other persons similarly situated, Plaintiff-Appellant,

v.

MIDWESTERN OKLAHOMA DEVELOPMENT AUTHORITY et al., Defendants-Appellees.

Fred A. W. FRANKE, on his own behalf and on behalf of all other persons similarly situated, Plaintiff-Appellant,

v.

MIDWESTERN OKLAHOMA DEVELOPMENT AUTHORITY et al., Defendants-Appellees.

Nos. 77-1640 to 77-1646.

United States Court of Appeals, Tenth Circuit.

Argued and Submitted Jan. 22, 1979.

Decided April 8, 1980.

Securities fraud actions were brought under Securities Exchange Act, SEC rule

"request" for a truly voluntary urine sample does not require hospital facilities.

Cronin v. Midwestern Oklahoma Development Authority, 619 F.2d 856 (1980)

10b–5 and antifraud provisions of Oklahoma Securities Act on behalf of purchasers of two industrial development revenue bond issues of development authority. The United States District Court for the Western District of Oklahoma, 428 F.Supp. 719, Luther L. Bohanon, J., granted summary judgment motions of defendant bond counsel and indenture-trustee banks and plaintiffs appealed. The Court of Appeals, William E. Doyle, Circuit Judge, held that: (1) summary judgment for defendants was precluded by genuine issue of material fact as to whether the defendants had violated the SEC rule both as principals and as aiders and abettors, and (2) order granting reimbursement to several defendants for attorney fees and costs for additional and unnecessary time spent attending portions of deposition of one defendant would be stayed, where it was too early to determine whether all of the cases involved interrelated schemes; thus trial judge should reconsider propriety and amount of reimbursement order following final disposition of the cases.

Remanded with directions.

1. Federal Civil Procedure ⟹2511

In securities fraud actions brought under SEC rule by purchasers of industrial development revenue bonds against bond counsel and indenture-trustee banks, summary judgment for defendants was precluded by genuine issues of material fact as to whether the defendants had violated the rule both as principals and as aiders and abettors. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); Fed.Rules Civ.Proc. Rules 30(g), 54(b), 28 U.S.C.A.

2. Securities Regulation ⟹117

To recover for violation of SEC rule relating to securities fraud, purchasers of industrial revenue bonds would not be required to establish that defendants, bond counsel and indenture-trustee banks, were privy to express fraud perpetrated by municipal bond broker-dealer and its salesman if it were shown that the underwriter and the defendants had participated in issuance of bonds and thus owed duty to all buyers to reveal facts, including depleted value of the bonds. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

3. Federal Civil Procedure ⟹2511

Because of limited time available for plaintiffs to develop their securities fraud claims against bond counsel and debenture-trustee banks, in connection with issuance of industrial development bonds, and in view of atmosphere of stress which pervaded the proceedings, summary judgment for defendants was improper. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 71 Okl.St.Ann. § 408; Fed.Rules Civ.Proc. Rules 30(g), 54(b), 28 U.S.C.A.

4. Federal Civil Procedure ⟹1451

Under rule providing that, if party giving notice of taking of deposition fails to attend and proceed therewith and another party attends in person or by attorney pursuant to the notice, court may order party giving notice to pay to such other party reasonable expenses incurred by him and his attorney in attending, including reasonable attorney fees, attendance without proceeding forward with a deposition is sufficient to invoke the sanctions. Fed.Rules Civ.Proc. Rule 30(g), 28 U.S.C.A.

5. Federal Courts ⟹943

Order granting reimbursement to several defendants for attorney fees and costs for additional and unnecessary time spent attending portions of deposition of one defendant would be stayed, where it was too early to determine whether all of the cases involved interrelated schemes; thus trial judge should reconsider propriety and amount of reimbursement order following final disposition of the cases. Fed.Rules Civ.Proc. Rule 30(g), 28 U.S.C.A.

6. Federal Civil Procedure ⟹1341

There was no authority for restraining plaintiffs from taking further depositions until they had deposited sum with court to be used in reimbursing defendants for attorney fees and costs incurred allegedly as result of additional and unnecessary time spent attending portions of another defendant's deposition. Fed.Rules Civ.Proc. Rule 30(g), 28 U.S.C.A.

J. Michael Rediker of Ritchie, Rediker & Warren, Birmingham, Ala. (Roger J. Nichols of Nichols & Rose, Beverly Hills, Cal. and Robert A. Jackson of Cassil, Jackson & Hall, Oklahoma City, Okl., with him on brief), for plaintiffs-appellants Michael P. Cronin and Fred A. W. Franke.

Thomas J. Kenan of George, Kenan, Robertson & Lindsey, Oklahoma City, Okl. (Robert C. Bailey of McClelland, Collins, Sheehan, Bailey & Bailey, Oklahoma City, Okl., with him on brief), for defendants-appellees Andrew J. Haswell, J. Dell Gordon and Haswell and Gordon.

James W. Shepherd, Oklahoma City, Okl. (A. P. Murrah, Jr., and Andrews, Mosburg, Davis, Elam, Legg & Bixler, Inc., Oklahoma City, Okl., with him on brief), for defendant-appellee Fred W. Rausch, Jr.

Reid E. Robison, Oklahoma City, Okl. (Reford Bond, Oklahoma City, Okl., and McAfee, Taft, Mark, Bond, Rucks & Woodruff, Oklahoma City, Okl., of counsel, with him on brief), for defendants-appellees Smith, Leaming & Swan, a Law Partnership, and its Partners, Hal D. Leaming and Roger H. Swan.

William W. Wiles, Jr. of Rhodes, Hieronymus, Holloway & Wilson, Oklahoma City, Okl., for defendants-appellees Blankenship & Harbour, Lawrence Blankenship and David M. Harbour.

William D. Curlee of Lytle, Soule & Emery, Oklahoma City, Okl., for defendants-appellees Sec. Bank and Trust Co. and Guaranty Trust Co.

Before SETH, Chief Judge, BREITENSTEIN and DOYLE, Circuit Judges.

WILLIAM E. DOYLE, Circuit Judge.

INTRODUCTORY

These two cases are each consolidated appeals from a series of orders of the U. S. District Court for the Western District of Oklahoma. Involved are two securities fraud actions brought under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j; SEC Rule 10b–5, 17 C.F.R. § 240.10b–5; antifraud provisions of the Oklahoma Securities Act, Okla.Stat.Ann. title 71 § 408; and common-law theories of fraud and negligence. Both cases were instituted as class actions on behalf of purchasers of two industrial development revenue bond issues of the Midwestern Oklahoma Development Authority (MODA). Both bond issues are now in default. Numerous defendants were named in each complaint, including the issuer, its officials, the private corporations which were to receive the bond proceeds, underwriters, bond counsel, and indenture trustees, as well as the broker-dealers who sold plaintiffs the bonds. Only the bond counsel and the indenture-trustee banks are parties to this appeal.

The trial judge granted summary judgment motions across-the-board of appellee-bond counsel and banks. The court also entered two orders under Fed.R.Civ.P. 54(b) directing entry of final judgment in each case so as to facilitate the appeals. Additional orders of the trial were also under Fed.R.Civ.P. 30(g). These restrained each plaintiff from taking further depositions until certain sums had been paid into the clerk of the court, as a sanction for alleged failure by the plaintiffs' counsel to cooperate with defendants' counsel by releasing the latter from continued attendance at the taking of the deposition of one R. J. Allen. The orders in each case were separately consolidated for purposes of appeal. Although the two cases themselves have not been consolidated, they do involve parties and issues sufficiently interrelated so that a single opinion is appropriate at this stage.

We have concluded that there was insufficient time allowed by the trial court to the plaintiffs to permit them to conduct adequate discovery on the merits of their cases. The plaintiffs were entitled to develop the evidence and formulate the applicable legal standards. The trial court is directed to vacate all of the summary judgment orders entered in each case. The cases as a whole are ordered to be remanded to the trial court with instructions to allow the parties additional time for discovery on the merits and for trial. We also vacate the several

orders in each case entered under Fed.R. Civ.P. 30(g) in accordance with the terms of the mandate set forth at the end of the opinion.

There is one other trial court order involved in these appeals, that is, the order dated March 31, 1977, directing plaintiff Cronin to serve a copy of the exhibit attached to the Nichols affidavit on each opposing party in the *Cronin* case. It is our understanding that Cronin has already complied with this order; therefore, no action is necessary with respect to it.

STATEMENT OF FACTS

The plaintiffs-appellants in each case, Michael P. Cronin and Fred A. W. Franke, are former Vietnam-era prisoners of war. Each were victims of a flagrant fraud which was initiated and brought about by a Florida municipal bond broker-dealer, Alexander & Allen, Inc., its officers and its salesmen. The principals of Alexander & Allen, including salesman Thomas A. Preston who sold Cronin and Franke the bonds in these cases, have been the subject of a civil injunctive action by the SEC and criminal proceedings as well. For a full discussion of the fraudulent activities of Alexander & Allen, Inc., see SEC v. R. J. Allen & Assoc., 386 F.Supp. 866 (S.D.Fla.1974). The crux of it is that representatives of Alexander & Allen preyed upon former POWs returning to the United States who had substantial sums of back pay accumulated during their years of imprisonment. These former POWs received substantial cash on release and were solicited to purchase high-risk industrial development bonds, with false representations that the bonds were safe and secure investments. The district court in *SEC v. R. J. Allen & Assoc., supra,* found that Alexander & Allen was a "boiler room," that is, a dealer offering securities of certain issuers in large volume through an intensive selling campaign, without disclosure of material facts concerning the issuers. *Id.* at 874. Although the principals of Alexander & Allen were named as defendants in these cases, two are in prison, all are apparently insolvent, and therefore none are parties in this appeal.

Among the securities featured by Alexander & Allen in its sales campaigns were industrial development bonds of the Midwestern Oklahoma Development Authority (MODA). MODA is an Oklahoma public trust organized in 1969 as a financing agency to attract industry to an area near the Clinton-Sherman Air Force Base in Oklahoma.

THE CRONIN CASE

Appellant Cronin purchased one $5,000 MODA Harper Industries 9% bond, Series 1972 B, due in 1985, through Alexander & Allen in August of 1973. The Harper Industries bonds were issued by MODA in two series, Series A and Series B, on the same date in July 1972 for the purpose of financing development of a plastic salt and pepper shaker manufacturing business. Supposedly, tool and die equipment was to be obtained, and leasehold improvements to a MODA-owned building at the Clinton-Sherman Industrial Airpark were to be made from the bond proceeds. The bond issue, which had a face amount of $1.3 million, was underwritten by United City Corp. (not a party to this case). Defendant-appellee Guaranty Trust Co. of Ponca City, Oklahoma served as indenture trustee. Two different law firms—each of which are appellees here—acted as bond counsel: Haswell & Gordon prepared a bond opinion concerning the legality and tax status of the Series B bonds; Fred W. Rausch, Jr. prepared an opinion concerning the Series A bonds. When Cronin received his Series B bond in the mail after purchase, the Rausch bond opinion addressed to the Series A bonds was enclosed. Cronin read the Rausch opinion, but he did not receive nor, of course, read a copy of the Haswell & Gordon opinion concerning the Series B bonds.

Cronin received interest on his Harper Industries bond coupon in January 1974, but his July 1974 coupon was returned unpaid. After learning that the bond issue was in default, he contacted the Navy JAG office in Washington, D. C. He served as a witness at the SEC proceedings against Alex-

ander & Allen. Later, Cronin contacted a private attorney and filed this class action under federal and state securities laws, as well as common-law theories of fraud, negligence and willful and wanton conduct. Cronin also sought punitive damages from the defendants, and an accounting firm from the defendant bank. Cronin's 10b-5 claim alleged that the defendants, including the appellee bond counsel and bank, violated or aided and abetted violations of Rule 10b-5 in the issuance of the Harper Industries bonds. Cronin claimed that the defendants were under a duty to disclose, but failed to disclose the following allegedly material facts:

1. That MODA had no adequate screening process to determine whether Harper Industries would earn sufficient revenues to pay the bonds;

2. That most of the MODA industrial development bond issues were in default;

3. That Harper Industries was undercapitalized. Consequently, after the bond issue the bonds would likely default;

4. That Harper Industries, as a single-product company, would have a high risk of failure;

5. That Harper Industries was a new and unseasoned company;

6. That Harper Industries would be located in a remote area of Oklahoma without a skilled or adequate labor force;

7. That defendants would divert part of the bond proceeds for their own benefit;

8. That the 30% underwriting discount was excessive and would have revealed the risky and speculative nature of the bond issue to the average buyer if disclosed;

9. That the bank was not qualified to act as indenture trustee.

THE FRANKE CASE

Appellant Franke purchased $10,000 worth of MODA Chill Can Mfg. 8% bonds due January 1, 1987, through Alexander & Allen in August 1973. The Chill Can bonds were issued by MODA on July 25, 1973 to finance a business manufacturing self-cooling containers and cans. The face amount of the issue was over $1.9 million. Alexander & Allen originally contracted to underwrite the Chill Can bonds, but defaulted on their underwriting contract. The bonds were finally underwritten by Stewart Securities Corp. and Fidelis Securities Corp., who became the underwriters. Each of the underwriters were originally named as defendants, but are not parties to this appeal. Appellee Security Bank & Trust Co. served as indenture trustee. Three different law firms, all appellees here, were involved with the Chill Can bond issue: Haswell & Gordon were originally designated by MODA as bond counsel, but withdrew three weeks before the closing date of the issue. Smith, Leaming & Swan and Blankenship & Harbour each prepared bond opinions on the legality and tax-exempt status of the issue. Franke read both the Smith, Leaming opinion and the Blankenship opinion after purchasing the bonds.

Franke received interest on the Chill Can bonds through July 1974, but in January 1975 his coupons were returned unpaid. On learning that the bonds were in default, Franke also retained counsel and brought a securities fraud class action paralleling the lawsuit filed by Cronin. Like Cronin's, Franke's complaint charged that defendants violated or aided and abetted violations of SEC Rule 10b-5 in issuance of the Chill Can bonds. Franke claimed that defendants, including the appellees here, were under a duty to disclose but failed to disclose the following allegedly material facts:

1. That MODA had no adequate screening procedures with which to determine whether Chill Can Manufacturing, Inc. would earn sufficient revenues to pay the bond interest;

2. That MODA's experience with IDBs such as the Chill Can issue was such that most issues ended in default;

3. That Chill Can Manufacturing, Inc., even after the bond issue, would be undercapitalized and that the bonds would likely be in default;

4. That Chill Can Manufacturing, Inc. was a single-product company with a high risk of failure;

5. That the company had never built a prototype of the can;

6. That the company would be located in a remote part of the state without a skilled or adequate labor force;

7. That certain defendants would divert part of the bond proceeds for their own benefit;

8. That the underwriting discount of 20% was excessive and would, if disclosed, indicate to the average buyer that the bonds were a highly risky and speculative security;

9. That the indenture trustee was unskilled.

THE DISTRICT COURT DECISIONS

The trial judge denied class certification in both the *Cronin* and the *Franke* cases. The plaintiffs have not attempted to appeal from these orders.

On November 12, 1976, the trial judge granted summary judgment for the law firm of Haswell & Gordon and its principals in the *Franke* case. The court ruled that, since the firm had withdrawn prior to the closing of the "Chill Can" bonds, it had not participated in the closing. The firm delivered no legal opinion, nor did it pass on the adequacy of any legal documents concerning the bonds.

The trial court also granted summary judgment for the trustee banks. The judge believed that the banks' duties were limited by the terms of their indenture agreements, and that therefore the banks had no duty of disclosure. The judge found that there was no evidence of scienter, as required by *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976). Further, the judge stated that the banks were not involved in structuring the bond issue or in selling the bonds to the plaintiffs. The court stated that the plaintiffs had not relied on the banks' conduct, and that reliance could not be presumed under *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972) because the banks were under no duty of disclosure to the plaintiffs.

The court's rationale for granting summary judgment for the bond counsel who did participate in the closings (Fred W. Rausch, Jr. and Haswell & Gordon in the *Cronin* case, and Smith, Leaming & Swan and Blankenship & Harbour in the *Franke* case) was similar to the rationale used for summary judgment for the indenture trustees. The court ruled that the plaintiffs had presented no evidence of scienter, in that the lawyers had no knowledge of the fraud committed by Alexander & Allen. The court found that the bond counsel's duties were contractually limited to such matters as expression of an opinion on the legality of the issue under state law and that the undisclosed facts had no bearing on this question; instead, that the omitted facts went to the economic feasibility of the project. The court believed that it was not appropriate to arbitrarily expand the obligations and potential liability of bond counsel to encompass a duty to investigate the economic soundness of bond issues. In the order pertaining to Rausch, the court stated that the connection with the plaintiff was even more remote, since Rausch's opinion covered a different series from the Series B bond purchased by Cronin. In the order concerning Haswell & Gordon in the *Cronin* case, the court found significant the fact that Cronin never read the Haswell & Gordon opinion.

The court also granted summary judgment against the plaintiffs on all of their state law claims, on grounds that the claims were barred by the applicable statutes of limitations, and, in the case of plaintiffs' tort theories, on grounds that the defendants owed no duty to the plaintiffs, *citing Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441, 74 A.L.R. 1139 (1931).

ISSUES TENDERED BY APPELLANTS

On this appeal, Cronin and Franke raise three issues. *First*, they question the legal standards for liability of bond counsel and indenture trustees under the antifraud provisions of the securities laws. They contend that bond attorneys and trustee banks may be liable, at least as aiders and abettors, if

the legal standards are satisfied, to the same extent as any other participants in securities transactions. *Second*, Cronin and Franke question the propriety of the trial court's summary judgment orders. They argue that, contrary to the trial judge's rulings, there exist substantial and disputed issues of fact and that summary judgment should, therefore, have been denied. A related question is whether the trial court afforded the plaintiffs an adequate opportunity to complete discovery on the merits of the case. *Third* and finally, the plaintiffs argue that the monetary sanctions imposed by the trial court under Fed.R.Civ.P. 30(g) in connection with taking the deposition of R. J. Allen were unwarranted.

I.

COMMENTS ON THE PROCEEDINGS IN THE DISTRICT COURT

[1] The pleadings allege that both the attorneys and the banks were guilty of violations of Rule 10b–5 both as principals and as aiders and abettors. The trial court's summary judgment orders have not distinguished between the two theories, and it would be presumptuous for us to discuss these approaches in the abstract. Whether the claims are sufficient under either the accessory or the principal theory must await development of the facts.

The trial judge's summary judgment orders are replete with conclusory statements that no duty was owed by the defendants to the plaintiffs Franke and Cronin. This again is dependent on facts, not on conclusions. Our conclusion at this premature stage of the proceedings is that either theory would be possible depending upon the ultimate evidence.

[2] There is one aspect connected with the remedy problem which deserves mention. That is the trial court's conception that the express fraud that was perpetrated by Alexander & Allen through their salesman Preston was the basic element in the alleged unlawful violation, and that the plaintiffs were required to establish that the defendant-bond lawyers and banks were privy to these acts. This is not necessarily so if the underwriter and the defendants are shown to have had participation in the issuance of the bonds and thus owed a duty to all of the buyers to reveal the facts including the depleted value of the bonds, and if the defendant-lawyers and banks knowingly aided the underwriter in the issuance of value-depleted bonds. Thus, conceivably there could be an aider and abettor claim or a claim based upon the theory that the defendants were principals. We mention this to illustrate the great importance of extending to defendants an opportunity to fully develop the facts surrounding the issuance of the bonds as well as all of the other background facts to be used at trial once the discovery is complete.

The defendants urge that the judge's ruling that there was a failure to establish existence of scienter on the part of these defendants was a correct one. Whether such element can be established depends again on whether there is evidence to establish the essential element of intent or reckless disregard of truth or falsity.

Similarly, reliance is a question of fact and not a question of law as the trial court appears to treat it. When causation is referred to in the present context, at least, it is synonymous with the element of reliance, but in this instance the problem is not one involving express representations. Instead, the contention of the plaintiffs is that there has been a failure or omission on the part of defendants to reveal material and relevant facts. It is obvious that if there was a failure to bring home facts that were known to the defendants and which they were required to reveal, the condition is such that there cannot be express proof of reliance and reliance is presumed. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972).

II.

INSUFFICIENT TIME FOR DISCOVERY ON THE MERITS

The main thrust of plaintiffs' argument and of this opinion is that the discovery was

prematurely cut short, and the consequence of this was that they were disabled from developing the facts and evidence supportive of their claim; that, further, in the proceedings below they were unable to offset the affidavits and motions for summary judgment of the defendants.

The shortness of time is revealed by a summary of the calendar. The complaint in *Cronin* was filed on January 6, 1976, and that in *Franke* was filed on February 20, 1976. Soon thereafter, on April 19, 1976, an order was entered by the trial court staying discovery on the merits of the case pending determination of the class issue. On December 29, 1976, the trial court entered its order denying certification of the class. This automatically terminated the stay on discovery and plaintiffs were then free to conduct discovery. On January 7, 1977, notice was served to take the deposition of R. J. Allen on January 14, 1977. On that date the deposition was only partially completed, and on February 10, 1977, plaintiffs served notice to take the depositions of ten additional witnesses during the latter part of April 1977. Summary judgment as to all of the defendants was granted before this discovery was completed. It was brought to the attention of the trial court that the discovery was incomplete at the time of the issuance of the summary judgments.

The time span between the filing of the summary judgments and their grant was short. In the *Cronin* case, Guaranty Trust Co. filed its motion for summary judgment on January 2, 1977. It was granted February 17, 1977. Haswell and Gordon's motion was filed November 18, 1976. It was granted February 18, 1977. The Rausch summary judgment motion was filed February 9, 1977. It was granted March 18, 1977. In *Franke*, the summary judgment motion of Smith, Leaming & Swan was filed April 1, 1976 and granted October 8, 1976. Haswell and Gordon's motion was filed in July 1976, and it was granted November 12, 1976. Blankenship & Harbour's motion was filed December 3, 1976 and granted February 18, 1977. The motion of Security Bank and Trust Company was filed January 21, 1977 and was granted in less than a month, on February 17, 1977.

The summary judgment is not a favored device in a case such as this, involving as it does a number of complex factual issues. The various elements of common law fraud as well as 10b–5 fraud are factual. When you add to that condition the curtailment of discovery, the judgments are on their face questionable.

[3] Considering then that these causes are highly complex, and considering also the fact that the legal responsibility of bond lawyers and the banks escrow holders is a new, relatively undeveloped issue, while the court should carefully and judiciously supervise the case, it should not prematurely terminate it. We reject the contention of the defendants that the plaintiffs were estopped to complain about the incompleteness of the record on the ground that the judgments were not final within the provisions of Rule 54(b). The defendants say that the plaintiffs had full opportunity to continue discovery and to show that material issues of fact were present and that they voluntarily brought the case to this court. This, however, loses sight of the fact that the atmosphere of the case was difficult, if not impossible, for the plaintiffs, and understandably they sought a fresh start. It was not only the haste of the trial court, it was the atmosphere of stress which pervaded the proceedings which created the difficulty.

III.

FED.R.CIV.P. 30(g) SANCTIONS

The final issue which we are asked to consider is the propriety of the order directing the plaintiffs to reimburse the defendants' costs and lawyers' fees incurred by them in connection with their attendance at the deposition of R. J. Allen. The plaintiffs gave written notice of the deposition to the defendants in six separate lawsuits. These included three cases pending in Alabama, one in Kansas, and the *Franke* and *Cronin* cases pending in Oklahoma.

The deposition was commenced on January 14, 1977 in Kingsville, Texas. The plaintiffs' counsel announced that he would first inquire of Allen with respect to general matters pertaining to all six cases, after which he would inquire as to the cases pending in Alabama and Kansas and, lastly, as to the two Oklahoma cases. After the general examination was completed at three o'clock in the afternoon, plaintiffs' counsel proceeded to question Allen on matters relevant only to cases other than the Oklahoma cases, but reserved the right to reopen the deposition as to any of the cases if something relevant to them was elicited. Counsel for the defendants in *Franke* and *Cronin* felt obliged to remain in attendance to protect the interests of their clients. The deposition was never reopened as to the *Franke* and *Cronin* cases. Efforts to postpone the deposition until an agreeable date in these cases were unsuccessful. Plaintiffs' counsel refused to release defendants' counsel from further attendance unless they agreed not to seek reimbursement from plaintiffs for expenses incurred in connection with the deposition. Finally, on the evening of Sunday, January 16, 1977, by stipulation, the deposition in *Franke* and *Cronin* was postponed until February 22, 1977, and counsel were excused.

Defendants Rausch, Security Bank & Trust Co., Guaranty Trust Co. and Haswell and Gordon moved for reimbursement under Rule 30(g), Fed.R.Civ.P., for attorneys' fees and costs for the additional and unnecessary time spent attending those portions of the Allen deposition which did not pertain to their cases. After a hearing, the trial court found that the plaintiffs had failed to properly proceed with the deposition as required by Rule 30(g) [1] and ordered the plaintiffs to deposit sums totaling approximately $5,000 with the clerk of the court to reimburse the defendants for the period of time they were required to be in attendance when the deposition was not proceeding on issues relevant to *Franke* and *Cronin*. The court also restrained the plaintiffs from taking further depositions until the money had been deposited with the clerk of the court, and a further order was entered that no party in the *Franke* or *Cronin* cases were to attempt to take depositions jointly with depositions in cases filed in other districts.

[4] The plaintiffs argue that Rule 30(g) requires that counsel fail to *attend* a noticed deposition as well as fail to proceed therewith before sanctions are imposed. This argument is inconsistent with the plain language of the rule as well as with its practical spirit and must be rejected. Attendance without proceeding forward with a deposition is sufficient to invoke the provisions of Rule 30(g). *See Detsch & Co. v. American Products Co.*, 141 F.2d 662 (9th Cir. 1944).

[5] Plaintiffs also claim that it was not unreasonable to refuse to release counsel in the *Franke* and *Cronin* cases because matters relevant to the cases were discussed during all portions of the deposition. It is further argued that all six of the cases involved interrelated nationwide fraudulent schemes. It is too early in the proceedings of these cases to determine the truth of this contention.

The order granting reimbursement is therefore stayed pending further proceedings. The trial judge should reconsider the propriety and the amount of the reimbursement order following the final disposition of these cases.

[6] A question remains as to the propriety of the restraint against further deposition taking by the plaintiffs until the reimbursement monies are deposited with the court. There is no authority for this sanction in Rule 30(g), and no case law to support it has been found. Further, the order was unnecessarily severe under the circum-

1. The applicable language of Rule 30(g) states:
(1) If the party giving the notice of the taking of a deposition fails to attend and proceed therewith and another party attends in person or by attorney pursuant to the notice, the court may order the party giving the notice to pay to such other party the reasonable expenses incurred by him and his attorney in attending, including reasonable attorney's fees.

stances and amounted to excessive punishment. That portion of the order must be vacated.

SETH, C. J., will file a separate opinion.

Exhibit G

[¶98,243] Securities and Exchange Commission v. Calhoun County Medical Facility, Inc.

United States District Court, Northern District of Mississippi. WC 81-66-WK-P. May 28, 1981. Order and Stipulation in full text.

Securities and Exchange Commission—Enforcement Proceedings—Consent Judgment—Attorneys—Bond Offerings—Undertakings.—As part of a consent judgment in an SEC enforcement proceeding, an attorney has undertaken to have the law firm in which he is a partner establish specified procedures relating to the firm's representation of issuers and underwriters in connection with bond offerings.

See ¶4815, "Securities Act—Liabilities" division, Volume 1.

Barton S. Sacher, Joseph L. Grant, Asst. Regional Administrator, Atlanta, Georgia, for plaintiff.

Henry L. Lackey, Calhoun City, Mississippi, for defendant Calhoun County Medical Facility, Inc.

Steptoe & Johnson, Judah Best, Washington, D.C., for defendants Bullington-Schas & Co., Inc.

Harvey L. Pitt, Washington, D.C., for defendant Sklar.

KEADY, District Judge: Plaintiff, Securities and Exchange Commission ("Commission"), having filed its Complaint herein; defendant, Jerald H. Sklar, ("Sklar"), having acknowledged receipt of a copy of the Complaint in the Stipulation and Consent filed in this action, having consented to the exercise of jurisdiction by the Court over him and the subject matter of this action; plaintiff Commission and defendant Sklar, having entered into the annexed Stipulation and Consent which is incorporated by reference herein and made a part of this Final Order; plaintiff Commission and defendant Sklar having waived the entry of findings of fact and conclusions of law under Rule 52 of the Federal Rules of Civil Procedure as to the issues involved in said Complaint; defendant having agreed, without admitting or denying the allegations of plaintiff Commission's Complaint, to the entry of this Final Order, and it appearing that this Court has jurisdiction over the parties and the subject hereof, and the Court being fully advised in the premises:

I. IT IS HEREBY ORDERED that defendant, Jerald H. Sklar, shall not, directly, indirectly, or through any other person or entity, in the offer or sale of any securities, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails: obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchasers or prospective purchasers, and, further, it is

II. ORDERED that JERALD H. SKLAR comply with the undertakings contained in the Stipulation and Consent attached hereto and incorporated herein by reference, and further, it is

III. ORDERED that the Court retains jurisdiction of this matter for purposes of enforcing this Order, and, further, it is

IV. ORDERED that, there being no just reason for delay, the Clerk of the Court is hereby directed to enter this Order with the Stipulation and Consent annexed hereto, and further, it is

V. ORDERED that, except as otherwise provided herein, this action against defendant Sklar be, and the same hereby is, dismissed with prejudice and without costs to either party.

Entered this 28th day of May, 1981.

STIPULATION AND CONSENT

Plaintiff Securities and Exchange Commission (the "Commission") and Defendant Jerald H. Sklar ("Sklar"), by and through their respective attorneys, hereby stipulate and agree as follows:

1. Defendant Sklar:

a. Consents to the jurisdiction of this Court over him and over the subject matter of this action and acknowledges service upon and receipt by him of the Commission's Complaint herein;

b. Waives notice of the entry of the attached Final Order, and consents without his admitting or denying the allegations of the Complaint, except as to jurisdiction, that the annexed Final Order may be presented by Plaintiff Commission to the Court for signature and entry;

c. States that he enteres into this Stipulation and Consent voluntarily and that, except for the representations of the Commission set forth herein, no promise or threat of any kind has been made to him or to any representative of his by the Commission or any member, officer, agent, employee or representative thereof to induce him to enter into this Consent, and that the Stipulation and Consent is entered into for the purpose of resolving the instant action and has no bearing on and shall not in any way prejudice or otherwise affect any other proceeding, civil, administrative or criminal, by any other governmental agency or private party, which has been or may be instituted;

d. Undertakes and agrees not to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon a purchaser of securities;

e. Undertakes to have the law firm in which he is a partner establish the following procedures:

i. insisting that the issuers of industrial development bonds that Mr. Sklar and his law firm represent in the future will furnish the firm with appropriate audited financial statements that have been certified by an independent accountant and insisting that the same information be furnished by the issuer when Mr. Sklar or the firm represents any other party, such as the underwriter or fiscal agent, involved in the distribution of such securities;

ii. meeting bi-weekly with all partners and associates of the firm involved in bond distributions to review all pending matters involving bond distributions;

iii. requiring the approval of at least three partners before any legal opinion is issued by the firm affecting the distribution of securities;

iv. delineating the scope of the firm's role and obligation both in an engagement letter to be presented to the issuer and underwriter in transactions in which the firm is to act as bond counsel, in connection with the issuance of securities, and in the official statement;

v. declining to participate in any industrial development bond offering unless the issuer, underwriter and other participants in the offering are each represented by counsel who are knowledgeable (and current in their knowledge) about the requirements of the federal securities laws; and

vi. requiring partners and associates in the law firm practicing securities law to update their familiarity with the federal securities laws by attending, at least annually, appropriate continuing legal education programs.

f. Undertakes to make himself available to and shall appear at any trial or hearing or pre-trial deposition in the above-captioned action at the oral or written request of the Commission, communicated to him or to his counsel of record herein, without requiring that such a subpoena be served upon him requiring such appearance; provided, however, that such request shall be communicated no less than two weeks before the Commission desires his attendance at any such trial, hearing or pre-trial discovery proceeding; and provided further, that if at the time any such notice respecting pre-trial deposition is communicated to him, Sklar shall be outside the United States, the time of his appearance shall be subject to reasonable adjustment except with respect to any trial or hearing as to which, if he receives the aforesaid notice, he shall appear on the date(s) requested;

g. States that he enter into this Stipulation and Consent to terminate these proceedings and to avoid the expenditure of additional cost and time, prior to any hearing, trial, adjudication or presentation of evidence;

h. Consents to the Court's retention of jurisdiction over him solely for the purpose of enforcing or modifying the terms and conditions contained in the Final Order and the Stipulation and Consent.

2. Plaintiff Commission:

a. Stipulates that it shall not institute any proceedings against Sklar or any law firm with which he is or may become associated under Rule 2(e) of the Commission's Rules of Practice [17 C.F.R. 201.2(e)] based solely upon (i) any of the allegations set forth in the Complaint filed in these proceedings; or (ii) the filing of the Complaint herein; or (iii) the entry of the Stipulation and Consent herein; or (iv) the entry of the Final Order herein. It is further stipulated that, in the event that a Rule 2(e) proceeding is instituted, if the independent factual and legal bases for such proceeding were not proven, the proceeding would be dismissed and no sanction would be imposed.

b. Stipulates that neither the entry of this Stipulation and Consent, nor the entry of the Final Order, nor the filing of the Commission's Complaint herein, nor the allegations set forth in the Commission's Complaint, shall be required to be disclosed in any proxy or registration statement, or offering statement, or any filing required to be made with the Commission under the federal securities laws, by any client of Mr. Sklar or by the client of any law firm with which Mr. Sklar is or may become associated (where Mr. Sklar acts solely in the capacity of attorney for such client and not in any other capacity defined in Securities Act Rule 405 [17 C.F.R. 230.405] such as officer, director, parent, affiliate, associate, control person or promoter of such client).

3. Plaintiff Commission and Defendant Sklar:

a. State that this Stipulation and Consent does not constitute any evidence or admission of any wrongdoing by Mr. Sklar, or an adjudication by the Court with respect to any issue of fact or law, and that no part of either this Stipulation and Consent or the Final Order is intended to have collateral estoppel effect upon Sklar or to preclude Sklar from fully litigating any such issue of fact or law in any other forum or jurisdiction.

b. Waive the entry of findings of fact and conclusions of law as to the issues involved herein pursuant to Rule 52 of the Federal Rules of Civil Procedure.

Securities Act of 1933 Release No. 5523
(August 21, 1974)
In the Matter of Jo M. Ferguson

Exhibit H

Model: Loan Agreement with
Note; Guaranty; Syndicate
with Representative
Exhibit A not attached

Revised 8/31/84

$______

[Name of Issuer]

__________ Revenue Bonds

(____________ Company Project) 19__ Series

BOND PURCHASE AGREEMENT

[Date], 19__

[Name of Issuer]
[address]

Attention:

[Name and Address of Company]

Attention:

[Name and Address of Guarantor]

Attention:

Dear Sirs:

The undersigned (the "Representative") acting on behalf of the several Underwriters named in Schedule I hereto (the "Underwriters"), offer to enter into the following agreement (the "Agreement") with you, the ________________________, a [municipal corporation] of the State of _______________ (the "Issuer"), ____________, a __________ corporation (the "Company"), and _________________, a __________ corporation (the "Guarantor"), which, upon your written acceptance of this offer, will be binding upon you and upon the Underwriters. This offer is made subject to your acceptance of this Agreement on or before ______ New York time on the date hereof and, if not so accepted, will

be subject to withdrawal by the Underwriters upon notice delivered to you by the Representative at any time prior to the acceptance hereof by you.

1. Purchase and Sale of Bonds. Upon the terms and conditions and upon the basis of the representations, warranties and agreements set forth herein, the Underwriters hereby agree, jointly and severally, to purchase from the Issuer, and the Issuer hereby agrees to sell to the Underwriters, the __________ Revenue Bonds (________________ Company Project) 19__ Series of the Issuer in the principal amount set forth in the heading of this Agreement (the "Bonds"). The Bonds shall be dated, shall mature and shall bear interest at the rate or rates as set forth on the cover of the Official Statement referred to below. The purchase price for the Bonds shall be [$__________ (representing __% of the principal amount of the Bonds)] plus interest accrued on the Bonds from their date to the date of the payment for and the delivery of the Bonds (such payment and delivery being herein sometimes called the "Closing").

The Bonds shall be as described in, and shall be issued and secured under the provisions of, an Indenture of Trust (the "Indenture"), dated as of __________, 19__, between the Issuer and ______________________, as trustee (the "Trustee"). The Bonds are to be issued in connection with the loan by the Issuer, pursuant to a Loan Agreement (the "Loan Agreement"), dated as of __________, 19__, between the Issuer and the Company, for the purpose of financing the Project (as such term is defined in the Loan Agreement). The Bonds will be payable out of payments made by the Company to the Issuer under the Loan Agreement, including payment under a promissory note (the "Note") delivered by the Company pursuant to the Loan Agreement, which the Issuer has assigned to the Trustee pursuant to the Indenture, and shall be guaranteed by the Guarantor pursuant to a Guaranty Agreement dated as of __________, 19__ (the "Guaranty") between the Guarantor and the Trustee. The Bonds will be special obligations of the Issuer payable solely out of revenues or other receipts, funds or moneys pledged therefor.

2. Official Statement. Concurrently with their acceptance hereof, the Issuer, the Company and the Guarantor will deliver to the undersigned an official statement dated the date hereof, signed on behalf of the Issuer, including an Appendix consisting of financial and other information in respect of the Company and the Guarantor. Such official statement, together with such Appendix, is hereinafter

called the "Official Statement". Each of the Issuer, the Company and the Guarantor hereby authorizes the use by the Underwriters of the Indenture, the Loan Agreement, the Guaranty and the Official Statement and any amendments or supplements thereto pursuant to this Section 2, and the information contained therein, in connection with the offering and sale of the Bonds. Each of the Issuer, the Company and the Guarantor hereby consents to the use by the Underwriters prior to the date hereof of a preliminary official statement dated _______________, including an Appendix consisting of financial and other information in respect of the Company and the Guarantor, in connection with the offering of the Bonds. Such preliminary official statement, together with such Appendix, is hereinafter called the "Preliminary Official Statement".

Subject to Section 7 hereof, during such period (terminating not later than 30 days after the delivery of the Bonds) as the Representative believes delivery of the Official Statement, as it may be amended or supplemented, is necessary or desirable in connection with sales of the Bonds, if any event shall occur as a result of which it is necessary to amend or supplement the Official Statement in order that the Official Statement not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made therein, in the light of the circumstances when the Official Statement is delivered to a purchaser, not misleading, the Issuer, the Company and the Guarantor will prepare and furnish to the Representative, at the Guarantor's expense, either amendments or supplements to the Official Statement so that the Official Statement, as so amended or supplemented, will not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made therein, in the light of the circumstances when the Official Statement is so amended or supplemented, not misleading. The Issuer, the Company and the Guarantor also agree that, before the Official Statement is amended or supplemented, they shall furnish a copy of each proposed amendment or supplement to the Representative who shall have the right to approve such amendment or supplement, which approval shall not be unreasonably withheld.

3. Sale of all the Bonds; Offering. It shall be a condition to the Issuer's obligation to sell and deliver the Bonds to the Underwriters to purchase and accept delivery of the Bonds that all Bonds be sold and delivered by the Issuer and accepted and paid for by the Underwriters at the

Closing. The Underwriters agree to offer all the Bonds, at a price not in excess of the initial offering prices, as set forth on the cover of the Official Statement, plus interest accrued thereon from their date to the date of the Closing.

4. Representations, Warranties and Agreements of the Issuer. The Issuer represents, warrants and agrees as follows:

(a) The Issuer is a body politic and corporate and a duly constituted and validly existing political subdivision of the State of __________, with full legal right, power and authority under and pursuant to Article ____ of the Annotated Code of __________ (the "Enabling Legislation"), to execute and deliver this Agreement, the Loan Agreement and the Indenture and to perform its obligations under each thereof and to issue and sell the Bonds pursuant hereto and to the Indenture.

(b) The Issuer has taken all necessary action and has complied with all provisions of the Constitution of the State of __________ and the Enabling Legislation, including but not limited to [add language re approval of Bond Authorization Ordinance and Bond Resolution], required to make this Agreement, the Loan Agreement, the Indenture and the Bonds the valid and binding obligations they purport to be; and, when executed and delivered by the parties thereto, this Agreement, the Loan Agreement and the Indenture will constitute legal, valid and binding agreements of the Issuer, enforceable in accordance with their respective terms, subject to applicable bankruptcy, insolvency and other laws affecting creditors' rights generally, and subject, as to enforceability, to general principles of equity (regardless of whether enforcement is sought in a proceeding in equity or at law). The Issuer has duly authorized all necessary action to be taken by it for the execution and delivery of the Official Statement.

(c) The Issuer will refrain from knowingly taking any action with regard to which the Issuer may exercise control that would result in the loss of the exemptions from taxation of the Bonds referred to under the caption "Tax Exemption" in the Official Statement.

(d) There is no action, suit, proceeding or investigation, at law or in equity, before or by any

court or governmental agency or body, pending or, to the best knowledge of the Issuer, threatened against or affecting the Issuer, wherein an unfavorable decision, ruling or finding would adversely affect the transactions contemplated hereby and by the Loan Agreement and the Indenture, or which, in any way, would adversely affect the validity of the Bonds, the Indenture, the Loan Agreement, this Agreement, or any agreement or instrument to which the Issuer is a party and which is used or contemplated for use in the consummation of the transactions contemplated hereby and by the Indenture or the exemption from taxation as set forth in the approving opinion of __________, Bond Counsel.

(e) The information contained in the Preliminary Official Statement and in the Official Statement under the caption "The Issuer", insofar as it relates to the Issuer, is true, correct and complete in all material respects, and such information does not contain any untrue or misleading statement of a material fact or omit to state any material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading.

(f) The Issuer agrees to cooperate with the Underwriters and their counsel in endeavoring to qualify the Bonds for offering and sale under the securities or Blue Sky laws of such jurisdictions of the United States as the Underwriters may request; provided, however, that the Issuer will not be required to execute a special or general consent to service of process or qualify as a foreign corporation in connection with any such qualification in any jurisdiction; and provided, further, that the Issuer's out-of-pocket costs in respect thereof are paid out of the proceeds of the Bonds or are otherwise provided for.

Any certificate signed [by any representative] of the Issuer and delivered to the Representative shall be deemed a representation and warranty by the Issuer to the Underwriters as to the statements made therein.

5. <u>Representations, Warranties and Agreements of the Company and the Guarantor</u>. The Company and the Guarantor represent, warrant and agree as follows:

(a) The Guarantor is a corporation duly organized, validly existing and in good standing under the

laws of the State of __________ and the Company is a duly organized, validly existing wholly-owned subsidiary of the Guarantor and is authorized and qualified to do business in the State of __________.

(b) At the date of execution by the Guarantor and the Company of this Agreement, the Official Statement is, and at all times subsequent thereto up to and including the Closing Date the Official Statement, as amended or supplemented pursuant to Section 2 hereof, will be, and the Preliminary Official Statement as of its date was, true and correct in all material respects for the purposes for which their respective uses are or were authorized; and the Official Statement does not, and the Preliminary Official Statement as of its date did not, include any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made therein, in the light of the circumstances under which they are or were made, not misleading, except that the foregoing does not apply to information contained under the captions "The Issuer" or "Underwriting".

(c) Except as may be specifically set forth in the Official Statement, there is no action, suit, proceeding or investigation, at law or in equity, before or by any court or governmental agency or body, pending or, to the best knowledge of the Company and the Guarantor, threatened (i) which might reasonably (x) result in material liability on the part of the Guarantor or the Company or (y) materially and adversely affect the operation, condition or feability of the Project or (ii) wherein an adverse decision, ruling or finding would (x) materially and adversely affect the transactions contemplated by this Agreement or (y) adversely affect the validity or enforceability of the Loan Agreement, the Bonds, the Indenture, the Note, the Guaranty or this Agreement.

(d) The audited financial statements with respect to the Guarantor and its consolidated subsidiaries included in the Appendix to the Official Statement or the Preliminary Official Statement, as the case may be, have been prepared in accordance with generally accepted accounting principles consistently applied throughout the periods concerned (except as otherwise disclosed in the notes to such financial statements), conform to the requirements of Regulation S-X of the

Securities and Exchange Commission and fairly present the financial position and results of operations of the Guarantor and its consolidated subsidiaries at the respective dates and for the respective periods indicated therein.

The unaudited financial statements, if any, with respect to the Guarantor and its consolidated subsidiaries included in the Appendix to the Official Statement or the Preliminary Official Statement, as the case may be (i) have been prepared in conformity with the generally accepted accounting principles reflected in the audited financial statements of the Guarantor and its consolidated subsidiaries at and for the years ended [December 31,] 19__, and [December 31,] 19__, respectively, included in such Appendix, and (ii) in the opinion of management of the Guarantor present fairly the financial position and results of operations of the Guarantor and its consolidated subsidiaries for the periods indicated therein and reflect all adjustments necessary to that effect.

(e) Substantially all of the proceeds of the Bonds will be used to finance [describe nature of Project] within the meaning of Section [add relevant section of 103] of the Internal Revenue Code of 1954, as amended; the Company will not take or omit to take any action which action or omission will in any way cause the proceeds from the sale of the Bonds to be applied in a manner contrary to that provided in the Indenture and the Loan Agreement, as in force from time to time.

(f) During the period between the date hereof and the Closing Date, the Guarantor will furnish to the Representative, promptly upon transmission thereof, copies of such financial statements and reports as it shall file with the Securities and Exchange Commission.

Any certificate signed by an officer of the Company or the Guarantor and delivered to the Representative shall be deemed a representation and warranty by the Company and the Guarantor to the Underwriters as to the statements made therein.

6. Closing. At 10:00 a.m., New York time, on __________, 19__, or on such later date within seven business days thereafter as shall be agreed upon in writing by

the Issuer and the Representative (the "Closing Date"), the Issuer will deliver the Bonds to the Representative for the account of the Underwriters in definitive form, duly executed and authenticated, in New York, New York, and will deliver to the Representative the other documents herein mentioned, at the office of [Salomon Brothers Inc] at One New York Plaza, New York, New York. The Representative will accept such delivery and pay the purchase price of the Bonds as set forth in Section 1 hereof by certified or bank cashier's check or checks, or by wire transfer, payable in New York Clearing House funds to the order of the Trustee. The Bonds shall be printed or lithographed on steel engraved borders, shall be prepared and delivered in such authorized denominations and shall be registered in such names as the Representative may request at least three business days prior to the Closing Date and, if the Representative shall so request, shall be made available to the Representative in New York, New York at least one full business day before the Closing for purposes of inspection and packaging.

7. Conditions of Closing. The obligation of the Underwriters to purchase and pay for the Bonds on the Closing Date shall be subject to the performance by the Issuer, the Company and the Guarantor, prior to or concurrently with the Closing, of their respective obligations to be performed under this Agreement and the accuracy of the representations and warranties of the Issuer, the Company and the Guarantor contained herein as of the date hereof and as of the Closing Date (it being specifically understood that for purposes of satisfying this condition and the conditions in paragraph (d), other than clause (iii) of paragraph (d)5, of this Section 7, the term "Official Statement" shall include any amendments or supplements thereto pursuant to Section 2 hereof), and shall also be subject to the following additional conditions:

(a) Each of the Indenture, the Official Statement (and any amendments or supplements thereto), the Loan Agreement, the Guaranty, and the Note shall have been duly authorized, executed and delivered, and each of the foregoing shall be in full force and effect and shall not have been amended, modified or supplemented except as may have been agreed to by the Representative.

(b) The marketability of the Bonds or the market price thereof shall not, in the opinion of the Representative, have been materially adversely affected by

(i) an amendment to or proposal to amend the Constitution of the State of __________ or any Federal or __________ legislation or proposed legislation or any decision of any Federal or state court or any ruling or regulation (final, temporary or proposed) or official statement on behalf of the Treasury Department of the United States, the Internal Revenue Service, or other Federal authority or authority of the State of __________, affecting the tax status of the Issuer, its property or income, its bonds (including the Bonds) or the interest thereon, (ii) an engagement in hostilities by the United States which shall have resulted in a declaration of war or a national emergency or any other national calamity, (iii) a general suspension of or material limitation on trading on the New York Stock Exchange or other national securities exchange, the establishment of minimum prices on such exchange or the declaration of a general banking moratorium by the authorities of the United States, the State of __________ or the State of New York or (iv) the establishment of any new restrictions on transactions in securities materially affecting the free market for securities or the extension of credit by, or the charge to the net capital requirements of, underwriters established by such exchange, the Securities and Exchange Commission, any other Federal or state agency or the Congress of the United States, or by Executive Order.

(c) No decision of any Federal or state court and no ruling or regulation (final, temporary or proposed) of the Securities and Exchange Commission or other governmental agency shall have been made or issued to the effect that (i) the Bonds or any securities of the Issuer or of any similar body of the type contemplated herein or the obligations of the Company under the Loan Agreement or the Note or of the Guarantor under the Guaranty are subject to registration requirements of the Securities Act of 1933, as amended or (ii) the qualification of an indenture in respect of the Bonds or any such securities is required under the Trust Indenture Act of 1939, as amended.

(d) At or prior to the Closing, the Representative shall have received the following documents, in each case satisfactory in form and substance to the Representative and to counsel for the Underwriters:

(1) The Official Statement signed on behalf

of the Issuer by the [Executive Director or Deputy Director].

(2) Two copies of the transcript of all proceedings of the Issuer relating to the authorization and issuance of the Bonds, duly certified by appropriate officials of the Issuer.

(3) A certificate, dated the Closing Date, of the [Executive Director or Deputy Director] of the Issuer, to the effect that, to the best knowledge of such official, (i) the representations and warranties of the Issuer contained in Section 4 hereof are true and correct on and as of the Closing Date as if such representations and warranties had been made on and as of the Closing Date and (ii) the Issuer has complied with all the terms of this Agreement, the Indenture and the Loan Agreement to be complied with by it prior to or concurrently with the Closing.

(4) A certificate, dated the Closing Date, of the [Executive Director or Deputy Director] of the Issuer, to the effect that, to the best knowledge of such official, there is no action, suit, proceeding or investigation at law or in equity before or by any court or governmental agency or body pending or threatened against the Issuer to restrain or enjoin the issuance or delivery of the Bonds, or the collection of the payments to be made pursuant to the Loan Agreement and the Note, or in any way contesting or affecting the validity of this Agreement, the Indenture, the Bonds, the Loan Agreement, the Note or the Guaranty or contesting the powers of the Issuer to enter into or perform its obligations under any of the foregoing.

(5) A certificate, dated the Closing Date, of an [appropriate executive officer] of the Guarantor, to the effect that, (i) the representations and warranties of the Company and the Guarantor contained in Section 5 hereof are true and correct in all material respects on and as of the Closing Date as if such representations and warranties had been made on and as of the Closing Date, (ii) the Company and the Guarantor have complied with all the terms of this Agreement and the Loan Agreement

to be complied with by them prior to or concurrently with the Closing, and (iii) since the date of the Official Statement or the date of the most recent financial statements of the Guarantor included or incorporated in the Official Statement, there has been no material adverse change in the condition (financial or other), earnings, business or properties of the Guarantor and its subsidiaries, whether or not arising from transactions in the ordinary course of business, except as set forth in or contemplated in the Official Statement.

(6) A certificate, dated the Closing Date, of the [appropriate executive officer] of the Company, to the effect that, to the best knowledge of such officer, there is no action, suit, proceeding or investigation, at law or in equity, before any court or governmental agency or body, pending or threatened against the Company to restrain or enjoin the payments to be made by the Company pursuant to the Loan Agreement, or in any way contesting or affecting the validity of this Agreement or the Loan Agreement or contesting the powers of the Company to enter into or perform its obligations hereunder or thereunder.

(7) A certificate, satisfactory in form and substance to the Representative, of one or more duly authorized officers of the Trustee, dated the Closing Date, as to the due acceptance of the Indenture by the Trustee and the due authentication and delivery of the Bonds by the Trustee thereunder.

(8) An approving opinion, dated the Closing Date, of _________________, Bond Counsel, in substantially the form attached as Exhibit A to this Agreement, together with a letter addressed to the Representative on behalf of the Underwriters to the effect that such opinion may be relied upon by the Underwriters to the same extent as if it were addressed to them.

(9) An opinion, dated the Closing Date, addressed to the Representative, the Company and the Guarantor, of ______________________, counsel to the Issuer, in substantially the form attached

as Exhibit B to this Agreement.

(10) A supplemental opinion, dated the Closing Date, addressed to the Representative, the Company and the Guarantor, of Bond Counsel in substantially the form attached as Exhibit C to this Agreement.

(11) An opinion, dated the Closing Date, addressed to Bond Counsel, the Issuer and the Representative, of _________________, Esq., [Vice President, General Counsel and Secretary of the Guarantor,] in substantially the form attached as Exhibit D to this Agreement.

(12) An opinion, dated the Closing Date, addressed to the Representative, of Cleary, Gottlieb, Steen & Hamilton, counsel for the Underwriters, with respect to the issue and sale of the Bonds, the Official Statement and other related matters as the Representative may require. In rendering such opinion, Cleary, Gottlieb, Steen & Hamilton may rely, without independent investigation, as to the Federal tax status of interest on the Bonds upon the opinion of Bond Counsel and as to matters of ___________ law upon the opinion of ___________.

(13) A letter from [Company's Independent Auditors], dated the Closing Date and addressed to the Representative, which shall confirm on the basis of a review in accordance with the procedures set forth in such letter that nothing has come to its attention during the period from [December 31, 19__,] to a date not more than five business days prior to the Closing Date which would require any change in its letter (in substantially the form attached as Exhibit E to this Agreement) dated the date hereof concerning the Official Statement if it were required to be dated and delivered on the Closing Date.

(14) Arbitrage certification by the Company and the Issuer.

(15) Such additional certificates, proceedings, opinions, instruments or documents as the Representative or counsel for the Underwriters may

reasonably request in connection with the transactions contemplated by this Agreement.

(e) Subsequent to the respective dates as of which information is given in the Official Statement, there shall not have been any change, or any development involving a prospective change, in or affecting the business, financial condition or properties of the Guarantor and its subsidiaries which change or development makes it impractical or inadvisable in the judgment of the Representative to proceed with the offering or the delivery of the Bonds as contemplated by the Official Statement.

(f) Subsequent to the execution of this Agreement there shall not have been any downgrading, suspension or official statement as to a possible downgrading of any rating by Moody's Investor's Service, Inc. or Standard & Poor's Corporation of any debt securities issued or guaranteed by the Guarantor, including the Bonds.

(g) All matters relating to this Agreement, the Bonds and the sale thereof, the Indenture, the Loan Agreement, the Note, the Guaranty and the consummation of the transactions contemplated by this Agreement shall have been approved by the Representative and counsel for the Underwriters, such approval not to be unreasonably withheld.

If the Issuer, the Company or the Guarantor shall be unable to satisfy the conditions to the obligation of the Underwriters contained in this Agreement, or if the obligation of the Underwriters shall be terminated for any reason permitted by this Agreement, this Agreement may be cancelled by the Representative, and, upon such cancellation, neither the Underwriters, the Issuer, the Guarantor nor the Company shall be under further obligation hereunder except as provided in Section 8 hereof.

8. Expenses. The Underwriters shall be under no obligation to pay, and the Company shall pay or cause the Issuer to direct the Trustee under the Indenture to pay from the proceeds of the Bonds, any expenses incident to the performance of the Issuer's obligations hereunder, including but not limited to (i) all expenses in connection with the preparation, printing and delivery of the Preliminary Official Statement, the Official Statement and any amendment or supplement to either, (ii) all expenses in connection with

the preparation, printing, issuance and delivery of the Bonds, (iii) all expenses in connection with the preparation, printing, issuance, delivery and recording or filing, if any, of the Indenture, the Loan Agreement, the Note, the Guaranty and this Agreement and any financing statement or notice with respect thereto, (iv) all expenses in connection with the preparation of Blue Sky and legal investment memoranda, if any, and the qualification of the Bonds for sale under the securities or Blue Sky laws of such jurisdictions as the Representative may designate, (v) all out-of-pocket disbursements and expenses of the Underwriters in connection with the sale and distribution of the Bonds, including the fees and disbursements of Cleary, Gottlieb, Steen & Hamilton, counsel for the Underwriters, (vi) the fees and disbursements of ______________________, Bond Counsel, (vii) the fees and disbursements of special counsel for the Company, if any, (viii) the fees and disbursements of the counsel for the Issuer, (ix) all expenses in connection with obtaining a rating or ratings for the Bonds and (x) all other expenses and costs of the Issuer, the Guarantor or the Company incident to the performance of their respective obligations in connection with the authorization, issuance, sale and distribution of the Bonds.

In the event that the Bonds are not sold by the Issuer to the Underwriters for any reason other than a default by the Underwriters, the Guarantor will pay or cause the Company to pay upon demand all expenses which would otherwise be paid from the proceeds of the Bonds pursuant to this Section and shall reimburse the Underwriters upon demand for all out-of-pocket expenses (including reasonable fees and disbursements of counsel) that shall have been incurred by any of them in connection with the proposed purchase and sale of the Bonds.

If the consummation of the transactions contemplated hereby is prevented by the default of the Underwriters, the Underwriters shall pay all such expenses except those referred to in clauses (vi) and (vii) above.

9. Indemnification.

(a) The Guarantor shall indemnify and hold harmless each Underwriter, the Issuer, each of their respective members, officers and employees and each person who controls an Underwriter within the meaning of Section 15 of the Securities Act of 1933, as amended (such Act being herein called the "Act" and any such

person being herein sometimes called an "Indemnified Party"), against any and all losses, claims, damages or liabilities, joint or several, to which they or any of them may become subject under any statute or at law or in equity or otherwise, and shall reimburse any such Indemnified Party for any legal or other expenses incurred by it in connection with investigating any claims against it and defending any actions, insofar as such losses, claims, damages, liabilities (or actions in respect thereof) arise out of or are based upon (i) an allegation or determination that the Bonds, the Note or the Guaranty should have been registered under the Act or the Indenture should have been qualified under the Trust Indenture Act of 1939, as amended, or (ii) any untrue statement or alleged untrue statement of a material fact contained in the Official Statement or any amendment thereof or supplement thereto, or in the Preliminary Official Statement, or the omission or alleged omission to state therein a material fact necessary to make the statements therein not misleading; provided, however, that the Guarantor shall not be liable in any such case to the extent that any such loss, claim, damage, liability or action arises out of, or is based upon, any untrue statement or alleged untrue statement of a material fact contained in that particular part of the Preliminary Official Statement, the Official Statement, or any amendment thereof or supplement thereto, under the captions "The Issuer" or "Underwriting", or the omission or alleged omission to state under either of such captions a material fact necessary to make the statements therein not misleading. This indemnity agreement shall not be construed as a limitation on any other liability which the Guarantor may otherwise have to any Indemnified Party, provided that in no event shall the Guarantor be obligated for double indemnification.

(b) An Indemnified Party shall, promptly after the receipt of notice of the commencement of any action against such Indemnified Party in respect of which indemnification will be sought against the Guarantor under this Section 9, notify the Guarantor in writing of the commencement thereof. Failure of the Indemnified Party to give such notice will reduce the liability of the Guarantor by the amount of damages attributable to the failure of the Indemnified Party to give such notice to the Guarantor; but the omission to notify the Guarantor of any such action shall not re-

lieve the Guarantor from any liability which it may have to such Indemnified Party otherwise than under the indemnity agreement contained in this Section 9. In case any such action shall be brought against an Indemnified Party and such Indemnified Party shall notify the Guarantor of the commencement thereof, the Guarantor may, or if so requested by such Indemnified Party shall, participate therein or assume the defense thereof, with counsel satisfactory to such Indemnified Party, and after notice from the Guarantor to such Indemnified Party of an election so to assume the defense thereof and approval by the Indemnified Party of counsel, the Guarantor will not be liable to such Indemnified Party under this Section 9 for any legal or other expenses subsequently incurred by such Indemnified Party in connection with the defense thereof other than reasonable costs of investigation; provided, however, that unless and until the Guarantor assumes the defense of any such action at the request of such Indemnified Party, the Guarantor shall have the right to participate at its own expense in the defense of any such action. If the Guarantor shall not have employed counsel, satisfactory to the Indemnified Party, to have charge of the defense of any such action within a reasonable time after notice of commencement of such action, or if an Indemnified Party shall have reasonably concluded that there may be defenses available to it and/or other Indemnified Parties which are different from or additional to those available to the Guarantor (in which case the Guarantor shall not have the right to direct the defense of such action on behalf of such Indemnified Party), legal and other expenses, including the expenses of separate counsel, incurred by such Indemnified Party shall be borne by the Guarantor.

(c) In order to provide for just and equitable contribution in circumstances in which the indemnification provided for in paragraph (a) of this Section 9 is due in accordance with its terms but is for any reason held by a court to be unavailable from the Guarantor on grounds of policy or otherwise, the Guarantor and the Underwriters shall contribute to the aggregate losses, claims, damages and liabilities (including legal or other expenses reasonably incurred in connection with investigating or defending same) to which the Guarantor and one or more of the Underwriters may be subject in such proportion so that the Underwriters are responsible for that portion represented by the percentage that

the underwriting discount set forth in the Official Statement under the caption "Underwriting" bears to the initial offering prices set forth on the cover of the Official Statement and the Guarantor is responsible for the balance; provided, however, that (y) in no case shall any Underwriter (except as may be provided in the Agreement Among Underwriters) be responsible for any amount in excess of the underwriting discount applicable to the Bonds purchased by such Underwriter and (z) no person guilty of fraudulent misrepresentation within the meaning of Section 11(f) of the Act shall be entitled to contribution from any person who was not guilty of such fraudulent misrepresentation. For purposes of this Section 9, each person who controls an Underwriter within the meaning of Section 15 of the Act shall have the same rights as such Underwriter. Any party entitled to contribution shall, promptly after receipt of notice of commencement of any action, suit or proceeding against such party in respect of which a claim for contribution may be made against another party or parties under this paragraph (c), notify such party or parties from whom contribution may be sought, but the omission so to notify such party or parties shall not relieve the party or parties from whom contribution may be sought from any other obligation it or they may have hereunder or otherwise than under this paragraph (c).

10. Notices. Any notice or other communication to be given to the Issuer, the Guarantor or the Company under this Agreement may be given by delivering the same in writing at such party's address set forth above, and any notice or other communication to be given to the Representative or the Underwriters under this Agreement may be given by delivering the same in writing to ____________________, ____________________, __________________________, Attention: Municipal Bond Department.

11. Parties in Interest; Survival of Representations and Warranties. This Agreement is made solely for the benefit of the Issuer, the Guarantor, the Company and the Underwriters (including the successors or assigns of any Underwriter), and no other person shall acquire or have any right hereunder or by virtue hereof. All the representations, and warranties and agreements made by the Issuer, the Guarantor or the Company in this Agreement shall remain operative and in full force and effect, regardless of (i) any investigations made by or on behalf of the Underwriters, (ii) delivery of and payment for the Bonds hereunder and

(iii) any termination of this Agreement.

12. Headings. The headings of the sections of this Agreement are inserted for convenience only and shall not be deemed to be part hereof.

13. Action by Representative. The Representative has been duly authorized to act on behalf of the Underwriters in connection with this Agreement, and any action taken by the Representative in connection herewith shall be binding upon all the Underwriters.

If you agree with the foregoing, please sign the enclosed counterpart of this letter and return it to the Representative. This letter shall become a binding agreement between you and the Underwriters when at least one counterpart of this letter shall have been signed by or on behalf of each of the parties hereto.

Very truly yours,

By____________________

The foregoing is hereby accepted as of the date first written above.

[Issuer]

By____________________

[Company]

By____________________

[Guarantor]

By____________________

Exhibit B

Opinion of Counsel to the Issuer*

1. The Issuer is a duly constituted and validly existing political subdivision of the State of _________, with the power and authority to finance the Project, and has full legal right, power and authority to issue the Bonds, to enter into the Bond Purchase Agreement, the Loan Agreement and the Indenture, and to carry out and consummate all other transactions contemplated by each of the aforesaid documents.

2. The Loan Agreement, the Indenture and the Bond Purchase Agreement have been duly authorized, executed and delivered by the Issuer and each constitutes a legal, valid and binding agreement of the Issuer, enforceable in accordance with its terms.

3. The Bonds have been duly authorized, executed and delivered by the Issuer and constitute legal, valid and binding obligations of the Issuer, enforceable in accordance with their terms.

4. No consents, approvals, authorizations or orders of any court or governmental body are required for the valid adoption by the Issuer the [Bond Resolution], the valid execution and delivery by the Issuer of the Loan Agreement, the Indenture and the Bond Purchase Agreement and the performance by the Issuer of its obligations thereunder, and the valid sale, issuance and delivery of the Bonds to the Underwriters, except such as have been obtained (specifying such consents, approvals, authorizations and orders) and except such as may be required under the Blue Sky or securities laws of any jurisdiction in connection with the offering and sale of the Bonds.

5. Neither the execution and delivery of the Loan Agreement, the Indenture, the Bond Purchase Agreement or the

* Sample provisions - actual opinion to be drafted in the context of each transaction.

Bonds nor compliance with the provisions thereof by the Issuer conflicts with or will result in a breach of any of the terms, conditions or provisions of any agreement, statute, regulation, court order or decree to which the Issuer is a party or by which it is bound, or constitute a default under any of the foregoing, or will result in the creation of any lien, charge or other security interest or encumbrance of any nature whatsoever upon any of the property or assets of the Issuer under the terms of any such agreement, instrument, statute, regulation or court order or decree, except as provided by the Bonds and the Indenture.

6. There is no action, suit, proceeding, inquiry or investigation, at law or in equity, before or by any court, public board or body, pending or, to the best of my knowledge, threatened against or affecting the Issuer nor, to the best of my knowledge, is there any basis therefor, wherein an unfavorable decision, ruling or finding would materially adversely affect the transactions contemplated by the Bond Purchase Agreement or by the Official Statement, or which, in any way, would adversely affect the validity or enforceability of the Bonds, the Loan Agreement, the Indenture or the Bond Purchase Agreement or any agreement or instrument to which the Issuer is a party or which is contemplated by the Bond Purchase Agreement or by the Official Statement.

7. Nothing has come to my attention which leads me to believe that the information set forth in the Official Statement with respect to the Issuer and the transactions of the Issuer contemplated thereby contains any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements therein, in light of the circumstances under which they were made, not misleading.

8. The Issuer has not granted a security interest in amounts payable to the Issuer under the Loan Agreement, nor have such amounts been otherwise pledged or encumbered, whether as original collateral or proceeds or otherwise, to secure any outstanding indebtedness of the Issuer other than the Bonds.

Such opinion may state that it is (A) subject to applicable bankruptcy, insolvency and similar laws affecting creditors' rights generally, and subject, as to enforceability, to general principles of equity (regardless of whether enforcement is sought in a proceeding in equity or at law),

and (B) qualified to the extent that the indemnification provisions contained therein may be limited by applicable securities laws and public policy.

Bond Counsel Supplemental Opinion*

1. It is not necessary, in connection with the offer, sale and delivery of the Bonds to the public, to register any security under the Securities Act of 1933, as amended, or to qualify an indenture under the Trust Indenture Act of 1939, as amended, and the Bonds are "exempted securities" for purposes of such Acts.

2. The Issuer has full power and authority under the Enabling Act (w) to enter into the Bond Purchase Agreement and to issue, sell and deliver the Bonds to the Underwriters as provided therein, (x) to enter into the Loan Agreement and the Indenture, (y) to lend the proceeds of the Bonds to the Company to pay the cost of acquiring and constructing the Project, all in accordance with the Loan Agreement and the Indenture and (z) to carry out and consummate all other transactions to be carried out and consummated by it pursuant to each of such instruments.

3. No consents, approvals, authorizations or orders of any court or governmental body are required for the valid adoption by the Issuer of the Bond Resolution, the valid execution and delivery by the Issuer of the Indenture, the Loan Agreement and the Bond Purchase Agreement and the performance by the Issuer of its obligations thereunder, and the valid sale, issuance and delivery of the Bonds to the Underwriters, except such as have been obtained (specifying such consents, approvals, authorizations and orders) and except such as may be required under the Blue Sky or other securities laws of any jurisdiction in connection with the offering and sale of the Bonds.

4. The adoption of the [Bond Authorization Ordinance and Bond Resolution], and the execution and delivery by the Issuer of the Bond Purchase Agreement, the Bonds, the Indenture and the Loan Agreement, will not conflict with or violate the Constitution of the State of ___________ or any

---

* Sample provisions - actual opinion to be drafted in the context of each transaction.

other existing provision of __________ legislation to which the Issuer is subject.

5. The Loan Agreement, the Indenture and the Bond Purchase Agreement have been duly authorized, executed and delivered by the Issuer, and each constitutes a legal, valid and binding agreement of the Issuer, enforceable in accordance with its terms. The Indenture creates the legal and valid pledge and lien which it purports to create of and on the [revenues or other receipts, funds or moneys pledged therefor in the Indenture], subject only to the provisions of the Indenture permitting the application thereof on the terms and conditions set forth in the Indenture.

6. Assuming the due authorization, execution and delivery by the Guarantor of the Guaranty, the obligation of the Guarantor to make all payments under and pursuant to the Guaranty constitutes a legal, valid and binding agreement of the Guarantor regardless of the invalidity or unenforceability of the Loan Agreement or the Note.

7. The Indenture has been duly recorded or filed in all offices in the State of __________ in which recording or filing is necessary in order to protect or preserve the lien of the Indenture or to publish notice thereof, and financing statements have been duly filed in proper form in all offices in the State of __________ where such filing is required in order to perfect any security interest created by the Indenture in favor of the Trustee in all the right, title and interest of the Issuer in and to the amounts payable to the Issuer under the Loan Agreement (but excluding certain rights to indemnification, expense reimbursement and enforcement); no other recording, rerecording, filing or refiling of the Indenture or any other instrument is required in order to protect the lien of the Indenture, to perfect the security interest created thereby or to publish notice of the Indenture, except (y) for such recordings or filings which may be required if the Indenture is amended or supplemented or the Issuer changes its name and (z) that, in order to continue the effectiveness of any financing statements which have been filed, continuation statements with respect to such financing statements should be filed in the manner and at the times prescribed by the [name of statute].

Such counsel shall also state that such counsel reviewed the statements contained in the Official Statement under the captions "Introductory Statement," "The Bonds," "The Loan Agreement," "The Note," "The Guaranty" and "The

Indenture"; that the statements under such captions (insofar as such statements constitute a summary of certain provisions of the documents referred to therein) fairly present the information purported to be shown, and do not contain any untrue statement of a material fact or omit to state any material fact necessary to make the statements therein, in the light of the circumstances under which they were made, not misleading; and that the summary of such counsel's opinion under the caption "Tax Exemption" accurately reflects the substance of such counsel's legal conclusions.

Such opinion may state that it is (A) subject to applicable bankruptcy, insolvency and similar laws affecting creditors' rights generally, and subject, as to enforceability, to general principles of equity (regardless of whether enforcement is sought in a proceedings in equity or at law)) and (B) qualified to the extent that the indemnification provisions contained therein may be limited by applicable securities laws and public policy.

Exhibit D

Opinion of Counsel to the Guarantor*

1. The Guarantor is a corporation duly organized, validly existing and in good standing under the laws of the State of __________; the Guarantor is qualified, authorized and licensed to engage in business in each jurisdiction wherein it owns or leases material properties or assets or the nature of the business conducted by it requires its qualification, authorization or licensing as a foreign corporation; each of the Guarantor and the Company has full power and authority to ehter into the Bond Purchase Agreement, to own its properties and to carry on its business as now conducted; the Guarantor has full power and authority to enter into the Guaranty; the Company has full power and authority to enter into the Loan Agreement and the Note; the Guarantor has a capitalization as set forth in the Official Statement as of the date referred to therein; and the Company is a wholly owned subsidiary of the Guarantor, duly organized, validly existing and in good standing under the laws of the State of __________ and is qualified, authorized and licensed to do business in the State of __________.

2. No consents, approvals, authorizations or orders of any court or governmental body are required for the consummation by the Company or the Guarantor of the transactions contemplated by the Loan Agreement and the Bond Purchase Agreement, except such as have been obtained (specifying such consents, approvals, authorizations and orders) and except such as may be required under the Blue Sky or other securities laws of any jurisdiction in connection with the offering and sale of the Bonds.

3. It is not necessary, in connection with the offer, sale and delivery of the Bonds to the public, to register any security under the Securities Act of 1933, as amended, or to qualify an indenture under the Trust Indenture Act of 1939, as amended, and the Bonds are "exempted securities" for purposes of such Acts.

---

* Sample provisions - actual opinion to be drafted in the context of each transaction.

4. The Bond Purchase Agreement, the Loan Agreement and the Note have been duly authorized, executed and delivered by the Company, and each constitutes a legal, valid and binding obligation of the Company enforceable in accordance with its terms.

5. The Guaranty has been duly authorized, executed and delivered by and constitutes the legal, valid and binding obligation of the Guarantor, enforceable in accordance with its terms regardless of the invalidity or unenforceability of the Loan Agreement or the Note.

6. Neither the execution and delivery of the Bond Purchase Agreement, the Loan Agreement, the Guaranty or the Note nor compliance with the provisions thereof by the Guarantor or the Company, contravenes the charter or by-laws of the Guarantor or the Company.

7. To the best knowledge of such counsel, there is no pending or threatened action, suit or proceeding before or by any court or governmental agency, authority or body or any arbitrator involving the Guarantor, the Company or the Project (or the transactions contemplated by the Bond Purchase Agreement or the validity or enforceability of the Loan Agreement, the Note, the Bonds, the Indenture, the Guaranty or the Bond Purchase Agreement) of a character required to be disclosed in the Official Statement which is not adequately disclosed therein.

8. Neither the execution and delivery of the Bond Purchase Agreement, the Loan Agreement, the Guaranty or the Note, nor compliance with the provisions thereof, by the Guarantor or the Company conflicts with or will result in a breach of any of the terms, conditions or provisions of any [corporate restriction] or of any agreement, instrument, statute, regulation, court order or decree to which the Guarantor or the Company is a party or by which it is bound, or constitutes a default under any of the foregoing, or will result in the creation or imposition of any lien, charge or other security interest or encumbrance of any nature whatsoever upon any of the property or assets of the Company under the terms of any such restriction, agreement, instrument, statute, regulation or court order or decree.

Such counsel shall also state that such counsel has no reason to believe that the Official Statement (except for the financial statements and other financial and statistical data included in the Appendix thereto, and the mate-

rial under the captions "The Issuer" and "Underwriting", as to which no belief need be expressed) contains as of the Closing Date (or contained as of the date of the Official Statement) any untrue statement of a material fact or omits to state any material fact necessary to make the statements therein, in the light of the circumstances under which they were made, not misleading.

In rendering such opinion, counsel may rely, without independent investigation, as to the matters of the law of the State of __________ upon the opinion of Bond Counsel or other counsel reasonably acceptable to the Underwriter.

Such opinion may state that it is (A) subject to applicable bankruptcy, insolvency and similar laws affecting creditors' rights generally, and subject, as to enforceability, to general principles of equity (regardless of whether enforcement is sought in a proceeding in equity or at law); and (B) qualified to the extent that the indemnification provisions contained therein may be limited by applicable securities laws and public policy.

Letter From Company's Independent Accountants*

1. We are independent accountants with respect to the Company within the meaning of the Securities Act of 1933 (the "Act") and the applicable rules and regulations thereunder.

2. In our opinion the audited financial statements and schedules thereto [included] [incorporated by reference] in the Official Statement and reported on by us comply as to form in all material respects with the applicable accounting requirements of the Act and published rules and regulations thereunder.

3. On the basis of a reading of the unaudited financial statements, the unaudited notes to the audited financial statements, [the supplementary financial information] and the "Selected Financial Data" [included] [incorporated by reference] in the Official Statement and of the latest unaudited financial statements made available by the Company and its subsidiaries; [our limited review in accordance with standards established by the American Institute of Certified Public Accountants of the unaudited interim financial information for the __ month period ended __________, 198_, and as at __________, 19__, as indicated in our report dated __________, 19__;] carrying out certain specified procedures (but not an examination in accordance with generally accepted auditing standards) which would not necessarily reveal matters of significance with respect to the comments set forth in the letter; a reading of the minutes of the meetings of the stockholders, directors and executive committees of the Company and the Subsidiaries; and inquiries of certain officials of the Company who have responsibility for financial and accounting matters of the Company and its subsidiaries as to transactions and events subsequent to __________, 19__, nothing came to our attention which caused us to believe that:

(a) the unaudited financial statements, the

---

* Sample provisions - actual opinion to be drafted in the context of each transaction.

unaudited notes to the financial statements [and the supplementary financial information] [included] [incorporated by reference] in the Official Statement do not comply as to form in all material respects with the applicable accounting requirements of the Act and of the published rules and regulations thereunder; and said unaudited financial statements are not fairly presented in conformity with generally accepted accounting principles applied on a basis substantially consistent with that of the audited financial statements [included] [incorporated by reference] in the Official Statement; or

(b) the amounts in the "Selected Financial Data" under the captions "____________________" and "______ __________________" for each of the [five] years ended ___________, 19__, [included] [incorporated by reference] in the Official Statement do not agree with the corresponding amounts in the audited financial statements from which such amounts were derived; and such amounts were not determined on a basis substantially consistent with the corresponding amounts in the audited financial statements.

(c) with respect to the period subsequent to ___________, 19__, there were any changes, at a specified date not more than five business days prior to the date of the letter, in the [longterm debt of the Company and its subsidiaries or capital stock of the Company]* or decreases in the [stockholders' equity of the Company and its subsidiaries]* or the consolidated net current assets of the Company and its subsidiaries, in each case as compared with the amounts shown on the ___________, 19__, consolidated balance sheet [included] [incorporated by reference] in the Official Statement, or for the period from ___________, 19__, to such specified date there were any decreases, as compared with

---

* The bracketed line items in paragraph (b) should normally be included in the comfort letter. However, the actual captions used should correspond to the captions used in the financial statements included or incorporated by reference in the Official Statement. In addition, other items, if any, applicable to the particular company should be added.

the corresponding period in the preceding year, in [net revenues, or in total or per share amounts of income before income taxes or of net income, of the Company and its subsidiaries,]* except in all instances for changes or decreases set forth in such letter.**

4. We have performed certain other specified procedures as a result of which we determined that certain information of an accounting, financial or statistical nature (which is limited to accounting, financial or statistical information derived from the general accounting records of the Company) set forth in the Official Statement under the captions "________________________________" agrees with the accounting records of the Company and its subsidiaries, excluding any questions of legal interpretation.

---

* The bracketed line items in paragraph (b) should normally be included in the comfort letter. However, the actual captions used should correspond to the captions used in the financial statements included or incorporated by reference in the Official Statement. In addition, other items, if any, applicable to the particular company should be added.

** In which case the letter shall be accompanied by an explanation by the Company as to the significance of such changes or decreases unless said explanation is not deemed necessary by the Representative.

5

EMERGING FINANCING TECHNIQUES

Michael A. Gort

July 15, 1985

Emerging Financing Techniques

I. **1985 Municipal Market Review**

A. Increased Borrowing by State and Local Government

1. Total Municipal debt increased from $65.05 billion in 1979 to $123 billion in 1984

2. Long-term debt volume increased 20% between 1983-1984

B. Increased Use of Revenue Bonds

1. Trends toward user fees

2. Statutory debt limitations for states and cities

3. Revenue bonds totaled $31.25 billion (72%) of tax-exempt market in 1979, $72.86 billion (78%) in 1984

C. Growth of Short-Term Market

1. Totaled $21.7 billion in 1979, $44.7 billion in 1982 (36% of Tax-Exempt Market)

2. 1982-1984 slight downward trend to $30.5 billion

a) Decrease partially due to 1984 Tax Bill and unclear tax-exempt status of HUD project notes

b) Drop in overall interest rate levels

c) Issuers "locking in" lower long-term rates

D. Insured Market Growth

1. Insured market volume $700 million in 1979, $20.9 billion in 1984

2. 1,132 insured issues in 1984

II. Development of New Financing Products

A. Products take advantage of market conditions

1. Yield curve benefits

2. "Shelf Registration"

B. New Financing Vehicles developed to appeal to broader markets

1. Investor preferences based on available returns on investments

2. Lower costs of financing and increased flexibility

C. New Products facilitate marketability of larger issues

D. Address market access problems due to over supply

1. Instruments can access long and short-term markets simultaneously

III. New Products

A. Convertible Capital Appreciation Bonds

1. Hybrid instrument combines zero coupon bond with full coupon bond

2. No coupon for initial period (i.e., 10 yrs.), full coupon thereafter

3. Lower cost to issuer vs. Capital Appreciation Bonds

B. Tax-Exempt Pension Liability Refinancing Bonds

1. City/State issues tax-exempt bonds to purchase annuity from insurance company

2. Eliminates unfunded pension liability

3. Creates more predictable stream of cash outflows for the City or State

4. Issuer has arbitrage opportunities (invest taxable, issue tax-exempt)

C. Flexible-mode put bonds

1. Issuer adjusts put period/interest rate adjustment period according to market conditions

2. Increased flexibility to issuer

3. Variation of predecessor short-term instruments

D. Money Market Municipals™

1. Provide individual rates for each fixed interest period

2. Provides lowest rates in the tax-exempt market for a long-term bond structure

3. Minimizes put risk and reissuance risk

E. Interest Rate Swaps

1. Hedge against exposure to floating rate risk

2. Bank or insurance company pays floating rate to issuer

3. Issuer pays the fixed rate to Bank or insurance company

4. Market fixed rate less swap fixed rate equals benefit to issuer

F. **Secondary Market Products**

1. **Tender Option Bonds**

   A. Enables financial institutions to sell below-market bonds without recognizing an accounting loss

   B. Institutions reinvest proceeds of sale in taxable securities and lock-in spread between tax-exempt and taxable market

   C. Bonds sold with a put option

   D. Program is considered a secured loan for accounting purposes of the financial institution

2. Variations of Tender Option Bonds have been developed with numerous advantages:

   A. Certain programs enable financial institutions to sell securities at par rather than at a discount (increased proceeds to seller)

   B. Put dates vary in frequency and therefore carry differing degrees of put risk

   C. The shorter put periods allow a greater spread to be earned on the put bond versus the mortgage bond income

   D. Certain programs can be marketed and remarketed to tax-exempt money market funds

IV. **Problems with New Products**

A. Remedy only specific portions of broad fundamental problems

B. Practical and legal issues aren't always fully addressed

C. Vulnerable to the "closing of loopholes"

D. Subject to interpretation

E. Example Problems

1. Philadelphia Gear Case

   a. FDIC Bank Letters of Credit may be taxable
   b. May adversely affect short-term debt in need of credit enhancements
   c. Increase demand for foreign bank L.O.C.'s

2. Problems in sizing refunding escrows

   a. Complicated if "put bonds" are used
   b. Defeasance problems

3. Impact of Technical Amendments concerning consumer loan bonds

   a. 5% rule regarding loans
   b. Impact on certain public power arrangements

V. Additional Restrictions on Tax-Exempt Financing

A. Use of Proceeds restrictions

B. Reissuance Problems

C. Arbitrage restrictions

VI. Solutions

A. Innovate in manner to address practical problems

B. Employ more traditional financing methods

C. Importance of planning

D. Become cognizant of the risk of the "leading edge"

NOTES

6

CREATIVE STATE AND LOCAL FINANCING TECHNIQUES

Robert S. Amdursky

Excerpted from a chapter in a two-volume treatise on the law of public finance to be edited by M. David Gelfand and published by Callaghan & Company in 1985.

June 24, 1985

338

CREDIT ENHANCEMENT TECHNIQUES

III. TENDER OPTION BONDS

§4:17. Introduction.

§4:18. Structure.

§4:19. Potential Problems and Proposed Solutions.

IV. VARIABLE RATE BONDS

§4:20. Introduction.

§4:21. Structure.

§4:22. Potential Problems and Proposed Solutions.

V. ZERO COUPON, MODIFIED ZERO COUPON AND COMPOUND INTEREST BONDS

§4:23. Introduction.

§4:24. Structure.

§4:25. Potential Problems Relating to Zero Coupon Bonds and Proposed Solutions.

§4:01. Overview.

In recent years, newly emerging concerns in the municipal market have resulted in purchaser resistance to traditionally structured tax-exempt financings. Fears of default and market value deterioration have made municipal obligations more difficult and costly to sell.

Traditionally, municipal securities have been considered the most secure category of investments second only to obligations of the federal government. Since 1975, however, New York City, Cleveland and Philadelphia have encountered serious financial problems, and California and Massachusetts have adopted tax reforms viewed by many experts as undermining the ability of their localities to repay newly incurred debt.[1] The New York State Urban Development Corporation and the Washington Public Power Supply System, the largest issuers of tax-exempt bonds in the country, have defaulted on their obligations.[2]

During roughly the same period, the value of long term municipal securities has been assaulted on yet another front. The Daily Bond Buyer, the national trade paper of the municipal finance industry, compiles and publishes an index showing the weekly average interest rate fluctuations in a portfolio of 20 selected high grade municipal bonds, known as the Bond Buyer 20-Bond Index. That Index rose steadily from a low of 6.07% per annum in 1978 to 12.96% per annum during the first quarter of 1982. Due solely to this market fluctuation, the holder of

even the highest grade long term bond issued in 1978 faced a loss of about 50% of his original investment if he was forced to sell the bond in 1982. The fact that the obligation would be paid in full at maturity 10 or 15 years later was little solace. Long term, fixed rate bonds were looked upon by many sophisticated investors with a marked lack of enthusiasm.

Neither the issuer, which is forced to pay higher interest rates, nor the purchaser, who seeks protection against these new risks, is content with traditionally structured municipal debt instruments. The task has fallen on legal and underwriting specialists to conceive and implement devices designed to eliminate risks involving the issuer's creditworthiness and to reduce the effects of market fluctuations.

This chapter will focus on letters of credit as instruments to accomplish both goals, as well as a range of instruments primarily designed to reduce market risks. These instruments include tax-exempt commercial paper, tender option bonds and variable rate obligations. Finally, zero coupon and compound interest bonds, products devised to appeal to the needs of a particular class of investors, will be examined.

I. LETTER OF CREDIT SECURED FINANCINGS

§4:02. Introduction.

Market concerns relating to issuer creditworthiness and market fluctuations have given rise to a number of creative uses of the letter of credit. In order to eliminate risks

involving an issuer's creditworthiness, its obligations may be backed by a letter of credit securing full and timely payment. In order to reduce the effects of market fluctuations, long term municipal bonds may be accompanied by a "put" which in turn is backed by a letter of credit.

A "put" is an option given the bondholder to tender his bond to the issuer or to a third party (collectively, the "Tender Obligor") on a specified date or dates; for example, weekly, monthly or annually. The Tender Obligor agrees to purchase the bonds at par plus accrued interest. As a result of the put, the bondholder's exposure to "market risk" is reduced to the period between the date of purchase and the first date on which the option to tender can be exercised. To assure the bondholder of the ability of the Tender Obligor to purchase bonds when tendered, the Tender Obligor frequently secures its obligation with a letter of credit.

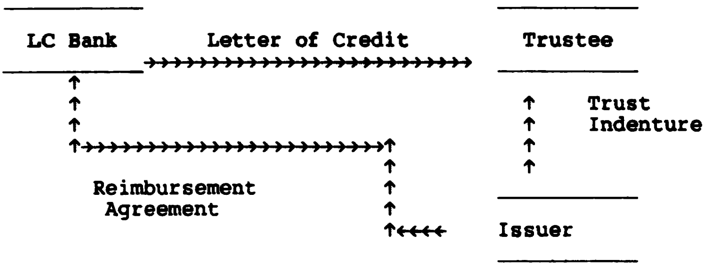
§4:03. Letters of Credit.

A letter of credit ("LC") is an obligation usually issued by a bank or savings and loan association (collectively, the "LC Bank") to pay a specified sum of money on demand of the beneficiary who complies with the terms of the LC. In a tax-exempt financing, the beneficiary of the LC will be the trustee for the bondholders (the "Trustee"), which is appointed by or pursuant to the trust indenture or bond resolution (collectively, the "Indenture") authorizing the issuance of the

bonds. Properly structured, the Trustee will have a claim against the LC Bank for the full amount of the obligation of the issuer (the "Issuer") or, in an industrial development bond ("IDB") financing, the company, hospital, developer, etc. which is the ultimate beneficiary of the financing (the "Private User").[3] The Trustee's claim is immediately payable upon presentation of the documents specified in the LC, whether or not the Issuer or, in an IDB financing, the Private User is then in bankruptcy, and the payment by the LC Bank will not constitute a preference payment for bankruptcy law purposes.[4] As a result, the bonds are given the same rating as obligations of the LC Bank or its holding company.

Illustration I demonstrates the relationship of the parties in LC secured financing where the Issuer is the real party in interest. Illustration II demonstrates the relationship of the parties in an LC secured IDB financing.

Parties in LC Secured Financing
Where Issuer Is Real Party In Interest



Indenture grants to Trustee as security for bonds:

1. Lien on Revenues produced by Facility or assets of Program
2. Mortgage on, and security interest in, Facility

LC provides that payments be made directly to Trustee

ILLUSTRATION II

Parties in LC Secured Financing
Where Private User Is Real Party In Interest

LC Bank	Letter of Credit →→→→→→→→→→→→→→→→→→→→→→→→	Trustee
↑ Reimbursement Agreement		↑ Trust Indenture
Company	Financing Agreement →→→→→→→→→→→→→→→→→→→→→→→→ (Lease, Sale or Loan)	Issuer

Indenture grants to Trustee as security for bonds:

1. Security interest in payments under Financing Agreement
2. Mortgage on, and security interest in, Facility

LC provides that payments be made directly to Trustee

§4:04. Characteristics of Letters of Credit.

The Comptroller of the Currency has ruled that each LC issued by a national bank should (1) conspicuously state that it is an LC, (2) contain a specified expiration date or be for a definite term, (3) be limited in amount, (4) be payable only upon presentation of a draft or other specified documents and not place the LC Bank in the position of having to determine questions of fact or law which may be conditions precedent to payment, and (5) be supported by an unqualified obligation by the bank's customer (the Issuer or Private User) to reimburse the LC Bank for payments made under the LC.[5]

An LC usually incorporates by reference the Uniform Customs and Practice for Documentary Credits (the "UCP"). The UCP specifies that all LCs should clearly indicate whether they are revocable or irrevocable. In the absence of such indication, an LC is deemed to be revocable.[6] If the UCP is not incorporated by reference in the LC, Article 5 of the Uniform Commercial Code will govern. Section 5-103 of the UCC makes no presumption as to revocability; whether it is revocable or irrevocable is a question of fact as to what the parties intended.[7] Obviously care should be taken to insure that the LC specifies on its face that it is irrevocable.

There are two general categories of LCs. A "direct pay" LC requires that the LC Bank pay directly to the beneficiary each amount secured by the LC. Thus, where a

direct pay LC backs a typical municipal bond, the LC Bank pays to the Trustee the amount of each semi-annual interest payment and each annual installment of principal. Pursuant to the credit or reimbursement agreement between the Issuer or Private User and the LC Bank (collectively, the "Credit Agreement"), the Issuer or Private User is obligated immediately to reimburse the LC Bank for the amount of each payment.[8]

A "standby LC," on the other hand, is drawn upon by the Trustee only once, usually upon a default by the Issuer or Private User in making a timely payment with respect to the bonds. In that circumstance, payment of the bonds is accelerated by the Trustee and the amount payable under the LC will equal all the unpaid principal of the bonds, accrued interest to the date of payment, up to a specified maximum, and premium, if any, up to a specified maximum.[9]

§4:05. Banking Law Issues.

The National Bank Act does not expressly authorize national banks to issue LCs; such power is implied as incidental to carrying on the business of banking.[10] Although the issuance of a guaranty by a national bank is ultra vires,[11] an LC has been held not to be a guaranty because a guarantor is secondarily liable for the primary obligation of another; the LC Bank, on the other hand, is primarily liable for its own obligation under the LC, dependent solely upon presentation of specified documents.[12] The Comptroller of

the Currency has specifically recognized the authority of a national bank to issue LCs.[13]

Similar issues relating to authority to issue an LC arise where the LC Bank is state-chartered. In all instances, therefore, prudent practice dictates that counsel to the LC Bank be required to render its opinion as to the legality, validity and enforceability of the LC.[14]

Except to the extent an LC is funded or collateralized by the Issuer, an LC constitutes a loan to the Issuer for purposes of the National Bank Act, which limits the total indebtedness that a national bank may extend to a single borrower to 15% of the bank's capital and unimpaired surplus.[15] If the LC Bank is state-chartered, counsel should investigate similar state law limitations.

§4:06. Federal Securities Law Issues.

An LC constitutes a "security" within the meaning of the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act") separate from the bonds of the Issuer and any other security for their repayment.[16] Generally, however, an LC is not subject to the registration requirements of Section 5 of the 1933 Act by reason of the application of Section 3(a)(2) of that Act. Section 3(a)(2) of the 1933 Act includes within the category of securities generally exempted from the Act "any security issued or guaranteed by any bank." A "bank," in turn, is defined as "any

national bank, or any banking institution organized under the laws of any State, territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official . . . ." The Securities and Exchange Commission ("SEC"), by "no-action letters," has extended the exemption to include LCs issued by domestic branches of foreign banks licensed and supervised by a state "banking commission or similar official."[17]

Even though an LC may be exempted from the registration requirements of Section 5 of the 1933 Act, its offer and sale (and the bonds it supports) are subject to the disclosure requirements of Section 10(b) of the 1934 Act and Rule 10b-5 of the SEC thereunder.[18] LC backed financings raise difficult disclosure issues. The credit to which the purchaser generally looks is solely, or mainly, that of the LC Bank. Hence, the financial condition of the LC Bank must be disclosed. Need any disclosure be made as to the financial condition of the Issuer or the Private User? There is no uniform practice, but persuasive arguments can be made that disclosure should be made about the Issuer or Private User, as well as the LC Bank.

What kind of disclosure about the LC Bank is appropriate? Should the latest Form 10-K and Form 10-Q of its holding company be reproduced in full in the Official

Statement? Can certain portions of such reports be reproduced? If less than all of such a report is included, will not difficult questions of material omissions inevitably arise? A more or less uniform practice has evolved in response to these questions: the prospective purchaser is referred to the holding company's latest filings with the SEC. The following excerpt constituted the entire disclosure about the financial affairs of Citibank, the LC Bank in a recent financing:

> Citibank is a wholly-owned subsidiary of Citicorp, a Delaware corporation, and is Citicorp's principal asset. Citibank is a commercial bank offering a wide range of banking services to its customers in the New York City metropolitan area, throughout the nation and around the world. The Consolidated Balance Sheet of Citibank (i) as at December 31, 1983 and as at December 31, 1982, set forth on page 39 of the 1983 Citicorp Annual Report and Form 10-K, and (ii) as at June 30, 1984, set forth on page 19 of Exhibit A of the Form 10-Q of Citicorp, is on file with the Securities and Exchange Commission. Citibank will provide without charge to any person to whom this Official Statement is delivered, on the request of such person, a copy of the 1983 Citicorp Annual Report and Form 10-K and Form 10-Q referred to above. Written requests should be directed to: Citibank, N.A., 399 Park Avenue, New York, N.Y. 10023, Attention: Office of the Secretary.

It should be noted that the aggregate amount of LCs issued by a national bank must be set forth in its financial statements.[19]

§4:07. Federal Tax Issues.

Section 103(a) of the Internal Revenue Code of 1954, as amended (the "IRC"), provides that interest payable on obligations issued by a state or political subdivision is exempt from federal income taxation. Section 103(b) extends that exemption to certain categories of IDBs which meet the conditions set forth therein.[20] How does the presence of an LC securing the payment of such a bond affect this exemption?

The Internal Revenue Service has ruled that the fact an IDB is secured by an LC does not affect the tax exempt status of the interest payable on the bonds for federal income tax purposes.[21] In Revenue Rulings 76-78, 72-575 and 72-134, the Service held that where timely payment of IDBs is insured by a private insurance company, the portion of the payment under the insurance policy representing interest is exempt from federal income taxes. In 1983, the Service held in a private letter ruling that since LCs "serve generally the same purpose as the insurance policies discussed in Rev. Ruls. 76-78, 72-575 and 72-134," the portion of an LC payment representing defaulted interest is exempt from federal income taxes.[22]

Section 103(h) of the IRC, added by the Deficit Reduction Act of 1984, denies tax-exempt status to interest on municipal obligations the repayment of which is directly or indirectly guaranteed by the United States. More specifically, Section 103(h) applies to deny tax exemption if either:

(1) the payment of principal or interest on the obligations is directly or indirectly guaranteed (in whole or in part) by the United States or an agency or instrumentality thereof,[23] or

(2) a significant portion of the proceeds of the obligations is invested directly or indirectly in federally insured deposits or accounts.[24]

Two recent federal court decisions have held that a standby LC issued by a national bank or a state-chartered bank that is a member of the Federal Reserve System constitutes a "deposit"[25] for the purposes of the Federal Deposit Insurance Corporation ("FDIC") and is insured by FDIC to the extent provided by law, at least where the account party evidences its obligation to repay draws on the LC by a promissory note.[26] FDIC is an agency of the United States.[27] Those decisions, therefore, raise the question whether interest on an issue of municipal obligations secured by such an LC is denied exemption from federal income taxation by reason of § 103(h).

Subsection (h) expressly provides that situation (1) above does not apply if there is a federal guarantee "merely by reason of the fact that . . . there is a guarantee by a financial institution."[28] The legislative history of this exemption states:

> Another exception to the general denial of tax-exemption provides that obligations shall not be treated as Federally guaranteed solely because . . . a financial institution guarantees repayment of the loans (e.g. issues a letter of credit).[29]

Thus, it would appear that an issue of municipal obligations secured by a standby LC should not be held to constitute an indirect federal guarantee described in (1) above.[30]

The remaining question is whether such a financing is one in which a significant portion of the proceeds is invested in federally insured deposits or accounts (i.e., the situation described in (2) above). This provision was directed at FDIC or Federal Savings and Loan Insurance Corporation ("FSLIC") insured bonds. The bond proceeds were used by the issuer to purchase certificates of deposit and the depositary institution then loaned the proceeds to the Private User. Under FDIC and FSLIC rulings, each bondholder was insured to the extent of $100,000.[31]

The technical answer is that in an LC-secured issue, proceeds of the municipal obligations are not invested in the LC; rather they are invested in what for tax purposes is a debt obligation issued by the Private User. Although the courts in the two decisions found the LC to be a "deposit" for FDIC purposes,[32] there was no "deposit" of bond proceeds in the LC within the meaning of the federal tax law.

Under the Internal Revenue Service's long-established published rulings position a "deposit or account" only exists where (1) there is a debtor-creditor relationship between the depositor and the recipient institution, and (2) the recipient institution treats its obligation as a deposit for purposes of

reporting to shareholders and banking authorities.[33] A "deposit" was found to exist in the two FDIC cases not because of a debtor-creditor relationship between the LC Bank and the beneficiary of the LC but because of a debtor-creditor relationship between the LC Bank and the LC account party created by a promise to repay draws on the LC given to the LC Bank by the account party.

Nevertheless, until these decisions have been reversed or Congress amends § 103(h) or the Treasury Department issues regulations confirming the above analysis, most counsel will not feel comfortable rendering unqualified tax opinions on LC secured obligations unless the financing is structured to avoid the problem. A number of alternatives are being explored. The solution that perhaps has gained the greatest support is the so-called "exploding" LC.

An "exploding" LC is one which by its terms automatically terminates, and any claim under the LC is extinguished, upon the closing of the LC bank on account of its inability to meet the demands of its depositors or upon the appointment of the FDIC as a receiver of the LC Bank. Since it is only after the happening of one of those two events that the Trustee or the bondholders otherwise would be entitled to claim the benefits of FDIC insurance and since upon the happening of either event the right to make such a claim is extinguished, it cannot be argued that the bonds directly or indirectly are guaranteed by the federal government.

The economic result of this solution, on the other hand, is far from satisfactory, since it leaves the bondholders with no claim against the insolvent LC Bank or its assets, even that of an unsecured creditor. This is particularly disquieting in view of the fact that LC secured financings generally are sold on the economic strength on the LC Bank. It goes without saying that full and prominent disclosure must be made in the Official Statement where an "exploding" LC is utilized.

As a practical matter, one also might attempt to distinguish the two federal court decisions by structuring the financing without any promissory note from the account party (as was present in each case) and by instead inserting in the Credit Agreement a contractual obligation on the part of the account party to make the payments in the event of a draw on the LC. There are at least two caveats to keep in mind in pursuing this course.

First, in one of the two decisions the court broadly construed a promissory note for these purposes to include "any written promise to pay,"[34] rather than the much more restrictive definition in the Uniform Commercial Code.[35] If that interpretation were accepted, the account party's promise to pay contained in the Credit Agreement would be treated the same as a promissory note and the attempt to distinguish the two cases would fail.

Second, a "deposit" for FDIC insurance purposes is defined by statute as "money or its equivalent" and, without

limiting the generality of that term, <u>requires</u> that any instrument must be regarded as the equivalent of money when issued in exchange for a promissory note.[36] Accordingly, even in the absence of a promissory note or acceptance of the broad interpretation of that term, the account party's obligation to repay advances under the LC could be judicially construed, outside the statutory mandate, as "money or its equivalent", thereby making the LC a federally guaranteed deposit.

Another attempt to avoid the effect of these two decisions would be to "waive" FDIC insurance on the LC. Neither federal law nor regulation appears to provide a method of accomplishing this result. However, the Trustee could covenant in the Indenture and each bondholder could covenant on its own behalf by accepting the bond not to make any claim against FDIC for any insurance to which it might otherwise be entitled.[37] Assuming the covenants are effective to preclude a claim against FDIC, a persuasive case could be made that there is no direct or indirect prohibited federal guarantee within the meaning of subsection (h). Even if such covenants are not effective -- for example, on public policy grounds -- they would clearly indicate that neither the Issuer nor the bondholder sought to violate the purpose of Section 103(h), coupling a federal guarantee with federal income tax exemption.

Section 103(c) of the IRC, which sets forth the so-called arbitrage restrictions, generally provides that bond proceeds may not be invested at a "yield" more than 1/8 of 1% higher than the bond yield, except during a temporary period after the issuance of the bonds or in the case of reserve funds.[38] Thus, the general rule is that the yield on the IDB loan to the Private User may not exceed the bond yield by more than 1/8 of 1% unless the Issuer (and the Private User) waive the temporary period, in which case the yield spread may be up to 1/2 of 1%.[39]

However, a different rule applies where bond proceeds are invested by the Issuer in acquired program obligations; that is, obligations acquired pursuant to a program which involves loans to a substantial number of persons representing the general public, such as residential mortgages, student loans, and so forth.[40] In these situations, the yield on the acquired program obligations may exceed the bond yield by up to 1-1/2%.[41]

Costs paid by the Issuer or Private User for issuing, carrying and repaying bonds are disregarded in calculating the yield spread for these purposes.[42] The Internal Revenue Service has ruled that the fee paid to an LC Bank for a standby letter of credit securing repayment of bonds "is a cost of carrying the issue".[43]

> The Letter of Credit fee is . . . [a cost] of carrying the bonds, because the letter

> of credit assures repayment of the bonds (as distinguished from the . . . [obligations] acquired with the bonds . . .), which assurance is a vital part of the issuance and marketing and . . . the repayment of, the bonds.[44]

Accordingly, if the LC is obtained by or on behalf of the Issuer to secure repayment of its bonds, the Issuer may increase the yield on its IDB loan or acquired program obligations in order to recover the amount of the LC fee, in addition to the spread otherwise permitted by the Section 103(c).

On the other hand, if the LC secures repayment of either the Private User's obligations to the Issuer or the acquired program obligations acquired by the Issuer with the proceeds of the bonds, rather than the bonds themselves, generally the LC fee must be paid out of the applicable spread permitted by Section 103(c). Normally, the amount of the LC fee makes this economically impossible or impractical. One method of avoiding this dilemma is for the Issuer to limit its spread to 1/8 of 1%, or 1/2 of 1% if the temporary period is waived. Under those circumstances, the Internal Revenue Service has ruled that the LC fee need not be taken into account in computing the yield spread since it constitutes an administrative cost outside the yield calculation.[45]

§4:08. Structure of LC Secured Financings as Affected by Bankruptcy Code.

An LC secured financing must be structured in a manner that is "preference proof." That is, the bondholder must be protected against having to disgorge a payment of principal or interest on the ground that such payment constituted a voidable preference under the Federal Bankruptcy Code, if the Issuer or Private User files a petition in bankruptcy within 90 days after the payment has been made.

A voidable preference under Section 547 of the Bankruptcy Code occurs upon a transfer of the debtor's property: (1) to or for the benefit of a creditor, (2) for or on account of an antecedent debt owed before the transfer was made, (3) while the debtor was insolvent, (4) on or within 90 days before the filing of a petition in bankruptcy by or against the debtor,[46] and (5) that enables the creditor to receive more than it would have received as part of a liquidation under Chapter 7 of the Bankruptcy Code.[47]

It has been held that the amount paid by an LC Bank in satisfaction of a call upon its LC is the property of the LC Bank, not of the debtor. Therefore the amount of such payment is not subject to the avoidance provisions of Section 547.[48]

With this in mind, there are at least three methods of structuring an LC secured financing that have proved acceptable to the rating agencies.

The first involves having the LC Bank pay the Trustee for the bondholders under a direct pay LC.[49] Payments under the LC should not be subject to avoidance as preferences, since such payments are not made from property of the debtor, at least where the Credit Agreement is not secured by property of the Issuer or the Private User.[50] A payment under the LC does not diminish the assets of the debtor available to other creditors. It merely substitutes a new creditor, the LC Bank, for the original creditors, the bondholders.[51]

Pursuant to the second alternative, the Issuer or the Private User pays the Trustee for the bondholders 105 days in advance of the bond payment date. If no petition in bankruptcy is filed within 90 days after receipt by the Trustee, the preference period has expired and a petition filed thereafter should not cause the payment to be a voidable preference.[52] If a petition is filed within 90 days after receipt of the payment by the Trustee, the Trustee pays the amount of the payment received from the Issuer or the Private User to the Bankruptcy Court and draws on the LC to pay the bondholders. The additional fifteen days (between 90 and 105) allows the Trustee a sufficient period within which to assure itself no petition has been filed.[53]

The third structure calls for the Issuer or the Private User to pay the Trustee for the bondholders immediately prior to the bond payment date and for the Trustee to pay the

amount due immediately over to the bondholders. If no petition in bankruptcy is filed within 90 days after payment to the Trustee, the payment should not be affected by the subsequent filing of a petition. At that time the amount of the LC is reduced by the amount of the debt service payment. If a petition in bankruptcy is filed within 90 days after payment to the Trustee, the Trustee for the bondholders calls on the LC for the entire amount due on the bonds, plus the amount of the payment made during the preference period. The outstanding bonds are redeemed and paid out of the LC proceeds. The amount of the payment made during the preference period is held in escrow. If the court holds that the payment is voidable and the bondholders are required to repay the last payment, the bondholders are made whole with the escrowed LC proceeds. If the court holds the payment is not a preference, the Trustee for the bondholders returns the funds to the LC Bank.

If the third alternative is chosen, care must be taken in drafting the LC and the Indenture, particularly with respect to the timing of reductions in the amount of the LC and the termination of the LC and the Indenture.[54]

Twist Cap v. Southeast Bank of Tampa[55] deals with the consequences of granting the LC Bank a security interest in property of the Issuer or Private User to secure its obligations under Credit Agreement, without a similar security interest being granted to the Trustee for the bondholders. In

Twist Cap, the bankruptcy court, fearing that a payment under the LC might cause the substitution of a secured creditor, the LC Bank, for unsecured creditors, the bondholders, enjoined payment under the LC. The bankruptcy court evidently believed that by preventing payment under the LC, it could avoid the attachment of a security interest in assets of the borrower in favor of the LC Bank.

Most experts are of the opinion that Twist Cap is wrongly decided because the security interest in favor of the LC Bank attaches at the time the LC is issued, not at the time of payment under the LC. Payment under the LC, therefore, is irrelevant to the relative positions of the claims of the LC Bank and the bondholders vis a vis the assets of the debtor. At least two bankruptcy courts have so concluded, ruling that payment under an LC should not be enjoined.[56]

Even though the validity of the Twist Cap decision is subject to considerable doubt, the rating agencies treat Twist Cap as a precedent that could affect the timeliness of payment in a LC secured financing. Therefore, to satisfy their concerns, the financing must be structured so that the bankruptcy trustee has no incentive to incur the expenses of litigation to enjoin payment of the LC.

This objective is achieved if one of the following three structures is adopted: First, no security is granted to the bondholders. The Issuer grants collateral security to the

LC Bank to secure its obligations under the Credit Agreement. The LC Bank agrees to hold the collateral for the equal benefit of itself and the bondholders. Second, security is granted to the bondholders pursuant to the Indenture. The LC Bank purchases the bonds with the LC payment and succeeds to the bondholders' security. Finally, neither the bondholders nor the LC Bank is secured. In this connection, it should be noted that where the LC Bank has a statutory or contractual right of set-off against balances of the Issuer or Private User on deposit with the LC Bank, the LC Bank should waive that right to avoid raising a _Twist Cap_ problem.

II. COMMERCIAL PAPER

§4:09. Introduction.

"Tax-exempt commercial paper" is a term of art used to describe a method of marketing tax anticipation notes ("TANs"), revenue anticipation notes ("RANs"), tax and revenue anticipation notes ("TRANs"), bond anticipation notes ("BANs") or other kinds of short term obligations of a tax-exempt Issuer.[57] The main attraction of tax-exempt commercial paper is its relatively short term, which may be as brief as several days or as long as 270 days.[58] Commercial paper offers the investor an opportunity to buy an obligation, usually at a discount, bearing interest and having a maturity which is designed to produce a yield throughout its life at or very close to market. Since the purchaser is not subject to the

risk of significant downward market fluctuations during the life of his investment, he is willing to accept a lower yield than on a longer term (e.g., a traditional one year) note. Indeed tax-exempt commercial paper generally results in the lowest interest rate possible for an Issuer.[59]

It is intended that each commercial paper obligation will be paid from the proceeds of a succeeding commercial paper obligation on the maturity date of the prior obligation. The key to a successful tax-exempt commercial paper program is a legal structure that enables the Issuer and its dealer to set a yield and term for each new obligation on the maturity date of the prior obligation and to issue, sell and deliver the new obligation <u>all on the same day</u>.

The major risk, other than the financial condition of the Issuer, in such a transaction is the inability of the Issuer to market its commercial paper on the maturity date of the prior obligation. To protect against this possibility, the Issuer generally enters into a standby funding arrangement; for example, a line of credit with a bank or group of banks. Under the line of credit, the Issuer may borrow an amount up to the maximum authorized principal amount of the outstanding commercial paper if the Issuer is unable to sell new commercial paper on the due date of an outstanding obligation.

§4:10. **Required Documents.**

The implementation of a commercial paper program requires a variety of resolutions, agreements and opinions. The most important of these are described in this portion of the chapter, and sample forms of them are included as exhibits.

§4:11. --Authorizing Resolution. The Issuer adopts a resolution or several resolutions (1) authorizing the issuance from time to time of up to $X in TANs, RANs, TRANs or BANs (the "Commercial Paper"), (2) authorizing a specified officer, generally its chief financial officer, to execute certificates setting the exact amount, date of issue, interest rate and term for each issue of Commercial Paper ("Issue Certificates"), (3) appointing an issuing and paying agent (the "Paying Agent") to authenticate and deliver each issue of Commercial Paper, (4) authorizing the execution of an agreement with an investment banker or commercial bank (the "Dealer") to market the Commercial Paper, (5) authorizing the execution of a revolving line of credit agreement (the "Credit Agreement") with one or more banks, (6) approving the use of a disclosure document (the "Commercial Paper Memorandum,"[60] and, sometimes, (7) authorizing the use of a credit enhancement device such as bond insurance or an LC.

§4:12. --Paying Agent Agreement. The Issuer appoints a banking institution as (1) a depository for the safekeeping of

its Commercial Paper, which has been pre-signed by an authorized officer of the Issuer and (2) its agent for the issuance, delivery and payment of its Commercial Paper. The amount, date of issue, rate of interest and maturity date of the Commercial Paper is left blank. Upon receipt of instructions from an authorized officer of the Issuer in a form specified in the Paying Agent Agreement (which generally is by telephone with subsequent confirmation in writing), the Paying Agent fills in the blanks, countersigns the Commercial Paper and delivers it to the Dealer.[61]

§4:13. --Dealer Agreement. The Issuer appoints an investment banker or commercial bank as exclusive dealer for its Commercial Paper on the terms and conditions contained in the Dealer Agreement. The Dealer is not obligated to buy any specific offering of Commercial Paper. The Dealer acts only as a "best efforts" underwriter. The Dealer Agreement may provide, however, that the Dealer must buy the Issuer's Commercial Paper if, and to the extent, the Dealer is unable to sell new Commercial Paper in an amount sufficient to retire the outstanding Commercial Paper.[62]

§4:14. --Credit Agreement. The Issuer may enter into an additional standby funding arrangement such as a credit agreement. Pursuant to such an agreement, a bank or group of banks agree, for a term up to 12 to 13 months, to lend the

Issuer from time to time an amount not to exceed the maximum authorized principal amount of Commercial Paper if the Issuer is unable to sell new Commercial Paper on the maturity date of the outstanding Commercial Paper. The Credit Agreement specifies the terms and conditions of the loan, including the interest rate, which usually is a percentage of the prime rate, and the respective obligations of all participating banks.[83] Whether the Issuer sells Commercial Paper to the Dealer, if the Dealer Agreement obligates the Dealer to purchase Commercial Paper under such circumstances, or borrows under the Credit Agreement is determined by the respective interest rates.

§4:15. —Bond Counsel's Opinion. Bond counsel renders its opinion on the date the initial Commercial Paper is issued. It is expected, however, that the opinion will be used by the Dealer in connection with multiple subsequent roll-overs for a period up to a year. This presents counsel with a number of serious problems since generally it conducts no "due diligence" investigation at the time of the roll-overs to determine if the factual and legal bases for its opinion continue to exist. How are any of the following handled: subsequent changes in law; amendment or repeal of the Authorizing Resolution; changes in the facts or expectations set forth in the arbitrage certificate executed at the time of initial issuance of the Commercial Paper; failure by the authorized officer to properly complete each Issue Certificate?

One approach is to advise purchasers in bond counsel's opinion that they may continue to rely on it only under certain specific circumstances. For example:

> You may continue to rely on this opinion with respect to Notes issued after the date hereof to the extent (1) there is no change in existing law subsequent to the date of issuance of this opinion, (2) the Resolution remains in full force and effect and has not been modified or amended, (3) such Notes as issued from time to time are authorized by an Issue Certificate duly completed, executed and filed with the finance board of the Issuer as required by applicable law, and (4) the representations, certifications and determinations set forth and recited in the Resolution, Arbitrage Certificate and each Issue Certificate are true and accurate on the date each of such Notes is issued.

Analagous problems are raised by the Commercial Paper Memorandum.[64] Prepared and delivered in connection with the initial issuance of the Commercial Paper, it nevertheless is expected to be used with all subsequent roll-overs. Typically, the Dealer Agreement will either call for a 10b-5 certificate from the Issuer's chief financial officer as of the date of each roll-over or provide that, in the absence of specific, written advice from the chief financial officer to the contrary, it is presumed that the Commercial Paper Memorandum remains true, correct and complete.[65]

§4:16. Preference Payment Problems.

The rating agencies require an opinion of counsel to the effect that payment by the Issuer of maturing Commercial

Paper will not constitute a voidable transfer under Section 547 of the Bankruptcy Code if the Issuer files a petition under Article 9 of the Bankruptcy Code within 90 days after such payment.[88] Section 547(c)(2) of the Bankruptcy Code provides an exception (the "Ordinary Course of Business Exception") to Section 547 where the payment is made (1) to discharge a debt that was incurred in the ordinary course of the business or financial affairs of the debtor and the transferee, (2) in the ordinary course of the business or financial affairs of the debtor and the transferee <u>and</u> (3) according to ordinary business terms. Some law firms have been able to render "reasoned opinions" that the Ordinary Course of Business Exception applies to tax-exempt commercial paper transactions.

III. TENDER OPTION BONDS

§4:17. <u>Introduction</u>.

In order to reduce the interest rate payable on long term bonds, an Issuer may offer purchasers the option to tender the bonds to the Issuer, the Private User or a third party (collectively, the "Tender Obligor") on a specified date or dates; for example, weekly, monthly or annually (a "Tender Date"). The Tender Obligor agrees to purchase the bonds at par plus accrued interest.

From the bondholder's standpoint, he or she owns an obligation in which his "market risk" runs only to the Tender Date as opposed to the stated maturity of the bonds, <u>e.g.</u>, 30

years. On each Tender Date, the bondholder can reassess the investment. If in light of then current market conditions he or she can find a higher yield on a comparable investment, the investor can exercise the option and get back the entire investment. On the other hand, if the bond is producing a yield equal to or higher than current returns, the investor can keep the bond and reassess his or her investment position on each Tender Date thereafter.

From the Issuer's standpoint, it is paying a current rate of interest substantially below interest rates on 30 year bonds. In a recent financing, a 30 year term bond with a three year "tender option" was sold at 185 basis points less than a comparably rated 30 year bond without a tender option. The Issuer is "gambling" that tax-exempt interest rates will not drop within three years. If it is wrong and bonds are tendered, the Issuer may have to refinance in whole or, more likely, in part sometime during the term of the financing at then current rates. On the other hand, if it has guessed correctly, the Issuer will have locked in a relatively low rate for 30 years or until interest rates drop to a level where it is advantageous for the Issuer to refinance.

Depending on the nature of the Issuer, its obligation to accept the tender may have to be secured, such as by an LC. An obligation which combines (1) a tender option exercisable on not more than seven days notice, (2) depending on the credit

quality of the Issuer or Private User, the credit enhancement of an LC, and (3) a variable rate, [67] qualifies as a portfolio investment for money market funds.[68]

§4:18. Structure.

The bondholder must deliver the bonds to the Trustee, as agent for the tendering bondholder, during a specified period prior to a Tender Date, together with a notice of the exercise of his option to tender and a properly executed instrument tranferring ownership of the bonds. The tender is irrevocable to and including the Tender Date.

Transfer of a debt instrument to the debtor generally results in a discharge of the debt.[69] Therefore, in order to keep the bonds outstanding, the tendered bonds must be accepted by the Trustee as agent for the tendering bondholders rather than as agent for the Issuer.

On a specified date prior to the Tender Date, the Trustee notifies the Tender Obligor of the aggregate amount of bonds tendered. The Tender Obligor then may (1) make a sufficient deposit with the Trustee and direct that the bonds be redeemed, (2) find a purchaser for the bonds or (3) purchase the bonds.[70]

While not all counsel agree, many are of the opinion that under the facts stated a purchase by the Private User of IDBs issued on its behalf would not cause them to be discharged. This conclusion is consistent with the decision of

the Court of Appeals for the District of Columbia in the Fairfax County Economic Development Authority v. Commissioner of Internal Revenue.[71] The Fairfax court held that, for federal tax purposes, the Issuer of an IDB, and not the ultimate beneficiary of the financing -- generally the Private User -- is the obligor on the bonds.

Moreover, the "substantial user" exception contained in Section 103(b)(13) of the IRC by implication recognizes that IDBs remain outstanding when owned by the Private User. It provides that interest on an IDB is taxable for any period during which it is held by a "substantial user" of the facilities constructed with the proceeds of the IDB.[72] If IDBs were not outstanding when held by the Private User, this provision would not be necessary.

§4:19. Potential Problems and Proposed Solutions.

When the Tender Obligor is not the Issuer or the Private User but a third party, it will demand compensation (the "Tender Fee") for the economic risk of having to purchase tendered bonds. The amount and method of payment of the Tender Fee is subject to negotiation between the Issuer or Private User and the Tender Obligor. If the Tender Fee demanded exceeds the interest cost savings, the tender option feature will be discarded.

Some counsel are of the opinion that a Tender Fee may be disregarded in calculating the "spread" permitted by the

arbitrage limitations of Section 103(c) of the IRC under the following conditions:[73] The tender option is issued separately from the bonds; the Tender Obligor is an entity other than the Issuer or the Trustee for the bondholders; and the Tender Fee is paid directly to the Tender Obligor by the bondholder.

Note that where the Issuer or the Private User, rather than a third party, is the Tender Obligor, all the issues relating to voidable preference apply to payments in satisfaction of the tender if the Issuer or Private User makes such payments within 90 days prior to the filing of a petition in bankruptcy.[74]

IV. VARIABLE RATE BONDS

§4:20. Introduction.

Variable rate bonds are another example of a device designed to make tax-exempt bonds a more attractive investment by protecting the holder against market risks. The closer the interest rate payable on an obligation is to the current rate on comparable obligations, the closer to par the obligation will trade in the market and the less risk the holder will bear of having his investment devalued by market, rather than credit, factors.

A variety of formulae have been devised in an attempt to assure the investor that the interest rate on the bond

always will approximate the then current market rate. These include (1) a percentage of the prime rate, adjusted as the prime rate changes, (2) a percentage of the prime rate, which percentage changes at prescribed intervals, (3) the average of the higher of the short-term interest factor or the long-term interest factor, calculated weekly, (4) the average interest rate on a specified number of comparable obligations, determined by a service such as Municipal Securities Evaluation Service Inc., adjusted periodically, and (5) such rate as an independent third party determines to be necessary in order for the bonds to sell at par.

§4:21. Structure.

The following are examples of language appropriate to implement each of these variable rate concepts:

Floating Prime

Interest on the unpaid principal balance of this bond shall be paid at a rate equal to seventy-five percent (75%) of the Prime Rate (being the rate of interest publicly announced from time to time by the Bank at its principal office as the Prime Rate), from time to time in effect, weighted for the number of days in effect, but in no event more than the highest rate permitted by applicable law. Each change in rate resulting from a change in the Prime Rate shall be effective as of the opening of business on the effective date of any change in the Prime Rate.

Adjusted Floating Prime

Interest on the unpaid principal balance of this bond shall be paid, during the periods hereinafter indicated, at the rate or rates of interest per annum (calculated on the basis of a 365/366-day year) equal to the following percentages set forth below, as in

effect from time to time, but in no event more than the highest rate permitted by applicable law:

Period (Both Dates Inclusive)	Applicable Rate
June 1, 1982 to and including May 31, 1987	62% of the Prime Rate
June 1, 1987 to and including May 31, 1992	64% of the Prime Rate
June 1, 1992 to and including May 31, 1997	66% of the Prime Rate
June 1, 1997 to and including May 31, 2002	68% of the Prime Rate
June 1, 2002 to and including May 31, 2007	69% of the Prime Rate
June 1, 2007 and thereafter	70% of the Prime Rate

Any change in the rate resulting from a change in the Prime Rate shall be effective on the effective date of each change in the Prime Rate announced by the Bank at its principal office.

Weekly Average of the Higher of Short- or Long-Term Interest Factor

Interest on the unpaid principal balance on this bond shall be paid at a rate equal to a per annum interest rate which is the arithmetic average of the weekly interest indices set forth below as in effect during the period commencing on the first business day following each interest payment date and ending on the fifth business day before the next succeeding interest payment date. The interest index determined each week will be the higher of the Short-Term Interest Factor or the Long-Term Interest Factor, determined as set forth below. However, each weekly interest index will be (i) not less than [____]% per annum, nor (ii) more than the lesser of [_____%] per annum or the maximum rate permitted by applicable law.

The Short-Term Interest Factor is ___% of the interest rate applicable to thirteen-week United States Treasury ("Treasury") bills and the Long-Term Interest Factor is ___% of the interest rate applicable to Treasury securities adjusted to a constant maturity of thirty years.

The Trustee will determine on each Tuesday the weekly interest index applicable to the Bonds and the arithmetic average of all such indices in effect during the current interest payment period. If any Tuesday is a day on which the Trustee is closed, such determination will be made on the next business day for the Trustee and applied as though determined on such Tuesday. All determinations respecting interest payable on the Bonds will be rounded to the nearest thousandth of one percent (the nearest 0.001%).

Index Determined by a Service

Interest on the unpaid principal balance of this bond shall be paid on the first business day of each calendar month and shall be computed on the basis of a year of 365 or 366 days, as appropriate, for the actual number of days elapsed. Interest on this bond will accrue from the first business day in each calendar month to and including the day next preceding the first business day in the following calendar month (each such period being hereinafter called an "Interest Period").

For each Interest Period the interest rate on this bond will be a percentage per annum equal to an interest index (the "Interest Index") which will be computed by the Indexing Agent, as of the last business day of the preceding Interest Period. However, in no event shall the interest rate borne by this bond exceed the lesser of 20% per annum or the maximum rate permitted by applicable law.

The Interest Index will be based upon 30-day yield evaluations at par of no fewer than 20 issuers of securities the interest on which is exempt from federal income taxation (the "Component Issuers") selected by the Indexing Agent which will include, without limitation, issuers of commercial paper, project notes, bond anticipation notes and tax anticipation notes. So long as the Bonds are rated in either of the two highest long-term rating categories by both Moody's and S&P, each of the Component Issuers will either have outstanding securities rated in the highest note or commercial paper rating category by either such agency or have outstanding securities rated in either of the two highest long-term debt rating categories by either such agency. In the event that the Bonds are rated in a rating category below the two highest long-term debt rating categories by

either Moody's or S&P, each of the Component Issuers will either have outstanding securities rated in the note or commercial paper rating category correlative to the rating category in which the Bonds are rated by either such agency or have outstanding securities rated in the rating category in which the Bonds are rated by either such agency.

The computation of the Interest Index by the Indexing Agent will be conclusive and binding upon the holder of this bond.

Rate Determined by Market

The Bonds shall bear interest at a variable rate determined by the Indexing Agent, on or before the second Business Day of each week for the seven day period commencing on Wednesday of the next succeeding week, to be a rate which, giving due regard to prevailing market conditions, would be the interest rate necessary (but which would not exceed the interest rate necessary) to cause the Bonds to trade at par on the secondary market[; provided, however, that the interest rate so determined shall not be (a) more than the highest of (i) 110% of the Interest Index, (ii) 15% per annum, or (iii) the maximum permitted by law or (b) less than the lower of (i) 90% of the Interest Index or (ii) 7% per annum].[75]

In a recent IDB financing, the bond provided for no fewer than six different possible rates of interest, including four different fixed rates, two of which were determined by reference to indices, and two different floating rates, both of which were determined by reference to indices.[76]

§4:22. Potential Problems and Proposed Solutions.

Some authorizing statutes require the Issuer to fix the interest rate payable on its obligations.[77] Under such provisions, a resolution of the Issuer authorizing the interest rate to vary from time to time or to be determined by reference to an external index, by a service or by the market may not be permissible.

The other major problem raised by variable rate bonds is whether a change in rates constitutes a new issue for federal tax law purposes. The general rule is that a renegotiation of a basic term of an obligation, such as the principal amount, maturity date or interest rate, will constitute a new issue.[78]

The Tax Equity and Fiscal Responsibility Act of 1982 imposes requirements on IDBs issued after June 30, 1983, relating to (1) public hearing and approval, (2) information reporting, (3) the use of proceeds to finance certain kinds of facilities and (4) the maturity of the bonds.[79] If a change in rate pursuant to any of these formulae constitutes a new issue for federal tax law purposes, how can an issuer comply with these requirements? If they cannot be complied with, and in most cases compliance would be impossible, does the interest on the bonds become taxable upon a change in rate? If the "sunset provision" pertaining to IDBs in Section 103(b)(6)(N) of the IRC takes effect, will a change in rate pursuant to one of the formulae after December 31, 1986 convert the bond issue from tax-exempt to taxable?

The only formulae on which there appears to be a unanimity of opinion among counsel that no reissuance question is raised are percentage of floating prime rate; a percentage of floating prime rate, which percentage changes at prescribed intervals; and the average of the higher of the short-term

interest factor or the long-term interest factor. In each of these cases, all the criteria upon which the change in rate are based are set forth in the original instrument and the mechanism for changing the rate is self-executing or determined by market forces outside the control of the Issuer or Private User.

Some IDBs are issued with an initial interest rate that is a variable rate tied to the average rate of a portfolio of comparable obligations. The Private User is given the option at any time to change the variable rate to a fixed rate based on a third-party determined index. A change from a variable rate to a fixed rate, particularly where the change is in the uncontrolled discretion of the Private User, raises serious reissuance problems. One solution is to condition the ability of the Private User to exercise its option upon the receipt by the Trustee of an unqualifed opinion of bond counsel to the effect that such change will not adversely affect the tax-exempt status of the interest on the bonds.

V. ZERO COUPON, MODIFIED ZERO COUPON AND COMPOUND INTEREST BONDS

§4:23. Introduction.

Zero coupon bonds are bonds on which the stated interest rate is 0% and on which no interest is payable until the maturity or redemption of the bonds. Such a bond is sold to the public at a substantial discount from its stated

principal amount, and its value -- disregarding market fluctuations -- increases on the basis of a semi-annual compounding of interest at the original issue yield (the "Compound Accreted Value"). For example, a $5000 zero coupon term bond maturing in 2017 was recently offered for sale at $175. Every six months the value of the bond will be increased by an internal compounding of interest at an annual rate of 9.7158%. At the end of year 1, it will have a Compound Accreted Value of $198.65; year 10, $466.55; year 20, $1,204.85; year 30, $3,111.40; and year 35, $5,000.

A zero coupon bond has two advantages to the purchaser: its very low purchase price and the automatic reinvestment of interest at a compound rate, in the example just cited, of approximately 10%. From the Issuer's standpoint, the advantage of a zero yield coupon was the ability to sell a 35 year bond at 9.7158% when comparable bonds were selling at approximately 12%.

A serious disadvantage to the Issuer is the large principal amount of zero coupon bonds which must be sold because of the relatively low amount of dollars actually received from the sale of such bonds. In the example under consideration, the Issuer sold $220,700,000 in zero coupon bonds and received net proceeds of only $6,550,000. Put differently, in order to raise $1 in proceeds, the Issuer had to issue $33.70 principal amount of bonds. In economic terms,

the difference between the principal amount of bonds issued and the proceeds received represent interest on the zero coupon bonds over their term which the Issuer "borrowed" but did not receive.

Compound interest or capital appreciation bonds (collectively, "compound interest bonds") are a variant of zero coupon bonds, designed to eliminate their main disadvantage while retaining some of their attractive features. Compound interest bonds bear interest at a stated rate, but the interest is compounded semi-annually at the stated rate and is paid only upon maturity or redemption of the bond. The initial offering price to the public of such a bond is par, and the value of the bond -- disregarding market fluctuations -- increases semi-annually by the amount of the compounded accrued interest.

The automatic reinvestment of interest at today's relatively high rates on a compounded basis, a feature shared with zero coupon bonds, has proved attractive to investors who do not want the burden, or risk, of reinvesting each interest payment semi-annually over the term of the bond. This feature has allowed compound interest bonds to sell at lower interest rates than bonds of comparable quality which do pay interest semi-annually. The interest rate savings is the attraction to the Issuer.

Since a compound interest bond is sold at par, rather than a substantial discount, it does not have the advantage --

from the investor's standpoint -- of a very low purchase price, or the disadvantage -- from the Issuer's standpoint -- of having to issue a principal amount of bonds many times the amount of proceeds actually received.

Yet another variation on this theme are obligations known variously as intermediate appreciation term bonds or growth and income securities (collectively, "modified zero coupon bonds"). Typically, principal on these obligations matures in one of the latest years of the bond issue.

Like zero coupon bonds, these obligations are sold at a substantial discount from par. Interest is accrued and compounded, rather than paid to the bondholders; but only for a specified period of time, not for the entire maturity of the bond. The period of compounding is that number of years necessary to bring the Compound Accreted Value of the bond -- i.e., its original purchase price, plus the compounded interest -- to the principal amount due at maturity. The Compound Accreted Value increases at the stated interest rate, compounded on each interest payment date, in equal daily amounts generally on the basis of twelve 30-day months. Thereafter, interest is payable semiannually on the stated principal amount.

This type of obligation is designed as a compromise, offering the Issuer and the investor some, but not all, of the advantages of zero coupon and compound interest bonds. The

investor benefits from a discount purchase price and, for a significant portion of the term of the bond, a guaranteed compounded interest at current rates. The Issuer benefits from a lower interest cost. On the other hand, the Issuer still must issue a greater principal amount of bonds than obligations sold at par in order to raise the same amount of capital.

§4:24. Structure.

The Indenture authorizing the issuance of zero coupon (including modified zero coupons) or compound interest bonds and the bond forms themselves must provide a table setting forth the Compound Accreted Value for zero coupon bonds, or the accrued interest for compound interest bonds. The table enables the bondholder or prospective purchaser to determine the value of a bond, excluding the effect on value caused by market interest rate fluctuations or by the creditworthiness of the Issuer.[80]

If zero coupon bonds were redeemed at their stated principal amount, the Issuer would be required to pay a substantial premium, in addition to any redemption premium actually provided for in the Indenture. In our example, if a $5000 bond were redeemed in year 10, the premium would be $4533.45; in year 20, $3795.15 (i.e., the difference between $5000 and the bond's then Compound Accreted Value). Conversely, if compound interest bonds were redeemed at their stated amount, the bondholder would be deprived of the value of

the accrued interest on his investment.[81] Accordingly, the redemption provisions of the Indenture must be rewritten to insure that zero coupon or compound interest bonds are redeemable only in accordance with the table.[82]

§4:25. Potential Problems Relating to Zero Coupon Bonds and Proposed Solutions.

A large principal amount of zero coupon bonds must be issued to raise a relatively small amount of proceeds. Zero coupon bonds, therefore, may be an inefficient use of an Issuer's bonding capacity if the Issuer is limited by a constitutional or statutory debt ceiling and if the outstanding amount of bonds is determined by the face amount of bonds issued, rather than the proceeds received. There is little precedent on the question as to what amount must be treated as outstanding for such purposes, so most bond counsel take the more conservative position that the entire face amount should be deemed outstanding in the year of issue.

By contrast, the Internal Revenue Service has ruled that in determining the amount of Mortgage Revenue Bonds issued against the "state ceiling" prescribed pursuant to Section 103A(g) of the Code, only the amount paid to the Issuer by the first buyer need be considered.[83] The Service reasoned that the purpose of the ceiling in Section 103A was to limit the amount of money that could be used within a particular state to finance residences with the proceeds of tax-exempt bonds.

Therefore, it concluded, counting the amount of proceeds received and not the stated principal amount served the statutory purpose.[84]

The federal income tax treatment of zero coupon bonds is fairly complex. The amount by which the stated principal amount of the bond exceeds the bond's initial offering price to the public (the "Discount") (1) is treated as tax-exempt interest under present law, (2) is deemed accrued by the bondholder under an actuarial compound interest basis from the date of original issue to the date of maturity and (3) is apportioned among the original and succeeding holders of the bond on such basis.[85] Accordingly, the holder of a zero coupon bond is treated as receiving in each annual period an amount of tax-exempt interest equal to the Discount accrued on a compound interest basis for the annual period. Where a holder sells a zero coupon bond during an annual period, the annual Discount accrual for the period is calculated on a straight line basis ratably between the portion of the period during which the holder held the bond and the balance of the period. The amount of Discount treated as having been received in accordance with this formula is added to the holder's tax basis for the purposes of determining gain or loss on a sale or redemption of a zero coupon bond. If the amount realized upon a sale of a zero coupon bond is in excess of, or less than, the holder's cost, plus the amount of Discount accrued to the date of purchase, the holder will recognize taxable gain or loss to that extent.[86]

FOOTNOTES

1 Christian Science Monitor, July 10, 1981, at 4; The Bond Buyer, May 8, 1981, at 3; Wash. Post, July 9, 1978, at A3.

2 Danziger and Ring, Fiscal Limitations: A Selective Review of Recent Research, 42 Pub. Ad. Rev. 47 at 50 (1982); N.Y. Times, February 26, 1975, at 1 Col. 1, and at 20 Col. 3 (New York State Urban Development Corporation default); N.Y. Times, July 23, 1983, at 29 Col. 1 and 6; N.Y. Times, July 26, 1983, at 1 Col. 4; The Bond Buyer, July 26, 1983, at 1 Col. 1; Wash. Post, July 23, 1983, at A1 (Washington Public Power Supply System default).

3 See Chapters 3 and 6.

4 See §4:08.

5 OCC Interpretative Ruling 7.7016, 12 C.F.R. 7.7016 (1983).

6 (a) Credits may be either (1) revocable, or (b) irrevocable.

(b) All credits, therefore, should clearly indicate whether they are revocable or irrevocable.

(c) In the absence of such indication the credit shall be deemed to be revocable.

Uniform Customs and Practice for Documentary Credits (1974 Revision) Art. 1a, b and c.

7 "Credit" or "letter of credit" means an engagement by a bank or other person made at the request of a customer and of a kind within the scope of this Article (Section 5-102) that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit. A credit may be either revocable or irrevocable. The engagement may be either an agreement to honor or a statement that the bank or other person is authorized to honor. U.C.C. § 5-103(1)(a) (1978).

The definition also makes clear that the engagement may be either revocable or irrevocable, the legal consequences of which are spelled out in Section 5-106 on the time and effect of establishment of a credit. Neither the definition nor any other section of this

Article deals with the issue of when a credit, not clearly labelled as either revocable or irrevocable falls within the one or the other category although the Code settles this issue with respect to the sales contract (Section 2-325). This issue so far as it affects an issuer under this Article is intentionally left to the courts for decision in the light of the facts and general law (Section 1-103) with due regard to the general provisions of the Code in Article 1 particularly Section 1-205 on course of dealing and usage of trade. U.C.C. § 5-103(1)(a) comment 1 (1978).

8 For text of a typical "direct pay LC", see Exhibit A.

9 For text of a typical "standby LC", see Exhibit B.

10 See Harfield, Bank Credits and Acceptances, 157-163 (5th Ed. 1974).

11 See Border National Bank v. American National Bank, 282 F. 73 (5th Cir. 1922), cert. denied, 260 U.S. 701 (1922).

12 See Republic National Bank v. American National Bank, 578 S.W.2d 109 (Tex. Sup. Ct. 1978). See also Barclays Bank v. Mercantile National Bank, 481 F.2d 1224 (5th Cir. 1973), cert. denied, 414 U.S. 1139 (1974).

13 "National banks, however, may issue standby letters of credit." OCC Interpretative Letter No. 78 (/1/25/79), (CCH) Fed. Banking L. Rep., Par. 85,153. See also OCC Interpretative Ruling 7.7016, 12 C.F.R. §7.7016 (1981).

14 For an example of a typical opinion of counsel to an LC Bank, see Exhibit C.

15 12 U.S.C. §84.

16 See Chapter on Federal Securities Laws, Chapter 9.

17 See Societe Generale - New York No-Action Letter [1981 Transfer Binder] Fed. Sec. Law Rept. (CCH) ¶ 76,775 (Sept. 25, 1980).

18 See Chapter on Federal Securities Laws: Disclosure, Chapter 9.

19 12 C.F.R. §11.7(c)(9)(viii).

20 See Chapter on Federal Tax Exemption: Industrial Revenue Bonds, Chapter 6.

21 IRS Letter Ruling 8108032 (November 25, 1980)

22 IRS Letter Ruling 8324063 (March 14, 1983)

23 IRC § 103(h)(2)(A), (C) and (B)(i).

24 IRC § 103(h)(2)(B)(ii).

25 12 U.S.C. § 1813(1)(1) defines a "deposit" as

> "the unpaid balance of money or its equivalent received or held by a bank in the usual course of business and . . . which is evidenced by . . . a letter of credit . . . on which the bank is primarily liable: Provided, that, without limiting the generality of the term 'money or its equivalent', any such account or instrument must be regarded as

evidencing the receipt of the equivalent of money when credited or issued in exchange for . . . a promissory note upon which the person obtaining any such credit or instrument is primarily or secondarily liable . . . ." (Emphasis added.)

26 Philadelphia Gear Corporation v. Federal Deposit Insurance Corporation, ____ F.2d ____ (Nos. 84-1901, 84-2007) (10th Circ. 1984); Allen, et al. v. Federal Deposit Insurance Corporation, ____ F. Supp. ____ No. Civ. 3-84-274 (E.D. Tenn. N.D. Oct. 24, 1984).

The Tenth Circuit, in Philadelphia Gear, rejected the argument that the promissory note did not constitute "money or its equivalent" because no advance had been, or was required or was expected to be, made on the note until there was a draw on the LC, an event which had not occurred. The court concluded that the issuance of the LC to which third parties could look for payment in reliance by the LC Bank upon the account party's execution of the promissory note made the transaction "one in which money or its equivalent [i.e., the LC] was issued in exchange for a promissory note."

The Tenth Circuit rejected the further argument that the LC Bank is not primarily liable on a standby LC within the meaning of 12 U.S.C. §1818(1)(1).

27 Colonial Bank & Trust Co. v. American Bankshares Corp., 439 F. Supp. 797 (D. Wis. 1977).

28 IRC § 103(h)(3)(D).

29 House Ways and Means Committee Report, March 5, 1984 (H. Rept. 98-432, Part 2, 98th Cong. 2d Sess.) p. 1690 (hereinafter, the "House Report"). Accord, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, prepared by the Staff of the Joint Committee on Taxation, December 31, 1984, p. 941, which, although not official legislative history, concludes that a letter of credit is a guarantee which is not effected "by means of Federal deposit insurance." Note that this General Explanation was written after both Philadelphia Gear and Allen had decided that standby LCs are deposits insured by FDIC.

30 It should be noted in this regard that Philadelphia Gear had been decided at the federal district court level on February 9, 1984, well before the bill embodying what is now subsection (h) was reported by the House Ways and Means Committee and almost a month before the House Report was issued.

31 Senate Report 98-169, Vol. 1, p. 694, 98th Cong. 2d Sess.

32 12 U.S.C. § 1813(1)(1).

33 See, e.g., Rev. Rul. 73-505, 1973-2 C.B. 224; and Rev. Rul. 70-436, 1970-2 C.B. 148.

34 Allen at p. 9.

35 UCC § 3-104(1)(b) defines a negotiable promissory note as

> "contain[ing] an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article . . . ."

UCC § 3-805 defines note as

> ". . . any instrument whose terms do not preclude transfer and which is otherwise negotiable within this Article but which is not payable to order or to bearer, except that there can be no holder in due course of such an instrument"

36 12 U.S.C. § 1813(1)(1).

37 The covenant on behalf of the bondholder would be placed on the face of the bond and state something to the effect that:

> "By accepting this bond, the bondholder hereby covenants and agrees that it will make no claim against the Federal Deposit Insurance Corporation for any insurance benefits to which it might otherwise be entitled as a consequence of any letter of credit securing the payment of this bond."

38 See Chapter on Federal Tax Exemption: Arbitrage.

39 Treas. Reg. § 1.103-13(b)(5)(i).

40 Treas. Reg. § 1.103-13(h). The differential between the yield on the bonds and the yield on the Issuer's investment of the proceeds of the bonds is referred to as the "spread".

41 Treas. Reg. § 1.103-13(b)(5)(viii).

42 Treas. Reg. § 1.103-13(c)(5)(iv)(A).

43 IRS Letter Ruling 8327016 (April 1, 1983).

44 Id.

45 IRS Letter Ruling 8328051 (April 12, 1983).

46 The period is extended to one year prior to the filing of a petition if the creditor is an "insider" and had reasonable cause to believe that the debtor was insolvent at the time of the transfer. See Chapter on Bankruptcy.

47 Chapter 7 of the Bankruptcy Code permits a secured creditor to receive the full value of the collateral securing his debt.

48 See Westinghouse Credit Corp. v. Page, 18 Bankruptcy Rptr 713 (D.C. D.C. 1982).

49 See note 8 and accompanying text.

50 See Westinghouse Credit Corp. v. Page, 18 Bankruptcy Rptr 713 (D.C. D.C. 1982); Twist Cap v. Southeast Bank of Tampa, 1 Bankruptcy Rptr 284 (Bankr. D. Fla. 1979).

51 For an opinion that such a structure is "preference proof", see Exhibit D.

52 See In re Knox Kreations, Inc., 656 F.2d 230 (6th Cir. 1981).

53 For an opinion that such a structure is "preference proof", see Exhibit E.

54 Exhibit F is the description in an Official Statement describing the provisions of such an Indenture.

55 1 Bankruptcy Rptr 284 (Bankr. D. Fla. 1979).

56 <u>See</u> <u>In re</u> M.J. Sales & Distributing Company, Inc., 25 Bankruptcy Rptr 608 (Bankr. S.D.N.Y. 1982) and Aetna Business Credit, Inc. v. Hart Ski Manufacturing Company, Inc., 7 Bankruptcy Rptr 465 (Bankr. D. Minn. 1980).

57 <u>See</u> Chapter on Municipal Obligations: Short-Term.

58 For the reasons discussed in Section 4:16 the term usually will be shorter.

59 <u>See</u> Devlin, '<u>Plain Vanilla' Can Taste Very Good</u>, The Bond Buyer, May 25, 1982, at p. 8; Chell, <u>Squared Issuers Take a New Look at Tax-Exempt Commercial Paper</u>, September 8, 1981, at p. 1; Chell, <u>High Demand, Law Rate Boost Tax-Exempt Commercial Paper</u>, May 15, 1981 at p. 3.

60 For an example of a typical tax-exempt commercial paper disclosure document for a general obligations issuer, see Exhibit G.

61 For an example of a typical tax-exempt commercial paper paying agent agreement, see Exhibit H.

62 For an example of a typical tax-exempt commercial paper dealer agreement, see Exhibit I.

63 For an example of a typical tax-exempt commercial paper credit agreement, see Exhibit J.

64 See Exhibit G.

65 See Exhibit K, particularly section 15, for a typical 10b-5 certificate from the Issuer's chief financial officer executed as of each roll-over date.

66 See Section 4:08.

67 See Part IV.

68 SEC Rule 2a-7.

69 See 2 Restatement (Second) of Contracts Sec. 274 (1981); 5A Corbin, Contracts Sec. 1250 (1964) See also Taylor v. Bocock, 276 So. 2d 347, writ denied, 279 So. 2d 205 (La. 1973).

70 For sample language from an Indenture implementing a tender option, see Exhibit L.

71 Fairfax County Economic Development Authority v. Commissioner of Internal Revenue, 77 T.C. 546, aff'd 679 F.2d 261 (D.C. Cir. 1982).

72 § 1.103(b)(13) reads as follows:

> "EXCEPTION -- Paragraphs (4), (5), (6) and (7) do not apply with respect to any obligation for any period during which it is held by a person who is a substantial user of the facilities or a related person."

See Chapter on Federal Tax Exemption: IDBs.

73 See Chapter on Federal Tax Exemption: Arbitrage.

74 See the discusssion of the Bankruptcy Code in § 4:08.

75 Recently, a number of issues have omitted the bracketed language, which was intended to establish objective standards.

76 Exhibit M is an excerpt from the Official Statement describing this floating rates/fixed rate bond issue.

77 N.Y. Local Finance Law § 51.00(5) (McKinney 1968); Ga. Code Ann. § 36-82-122 (1983); Ind. Code Ann. § 5-1-4-13 (Burns 1983).

78 See Rev. Rul. 81-281; c.f. Thomas Watson, 8 T.C. 569 (1947), acq 1947-2 C.B. 5; Thomas Emery, 8 T.C. 979, aff'd 48-1 USTC ¶ 9165 (2d Cir. 1948); Girard Trust Co. v. U.S., 166 F.2d 773 (3d Cir. 1948). See generally Winterer, "Reissuance" and Deemed Exchanges Generally, 37 Tax Lawyer 509 (1984).

79 I.R.C. § 103(k), § 103(c), § 103-1(b)(14). See Chapter on Federal Tax Exemption: Arbitrage.

80 For a sample Compound Accreted Value table for zero coupon bonds, see Exhibit N; and for a sample accrued interest table for compound interest bonds, see Exhibit O.

81 See Exhibit O.

82 For sample Indenture provisions for redemption of zero coupon bonds, see Exhibit P.

83 Rev. Rul. 83-154 (10/17/83).

84 Since the Issuer is obligated to pay the full face amount of zero coupon bonds on maturity or their Compound Accreted Value upon redemption and since taxes will have to be levied to meet this obligation, the Service's reasoning would not appear to be apposite in the case of general obligation bonds.

85 See I.R.C. § 163(E), Treas. Reg. § 1.163-3 & 4.

86 For a legal opinion regarding the treatment of original issue discount for federal income tax purposes, see Exhibit Q.

NOTES

7

MUNICIPAL BANKRUPTCY - PROBABILITY AND EFFECT -- CURRENT PROBLEMS, POSSIBLE SOLUTIONS, AND PROPOSED LEGISLATIVE CHANGES

James E. Spiotto

 A portion of this material was taken from a chapter by the author which will appear in a two-volume treatise, The Law of State and Local Government Debt Financing to be edited by Professor Donald Gelfand to be published by Callaghan & Co. in late 1985 and from the Treatise, Financial Workouts and Other Alternatives to Litigation and Bankruptcy to be published by Callaghan and Co. in 1986.

TABLE OF CONTENTS
(Please refer to page numbers at the top of the text)
MUNICIPAL BANKRUPTCY: PROBABILITY AND EFFECT

(Current Problems, Possible Solutions,
and Proposed Legislative Changes)

1

MUNICIPAL BANKRUPTCY: PROBABILITY AND EFFECT

(Current Problems, Possible Solutions, and Proposed Legislative Changes)

NOTE: The following outline and Appendices A, B and C are background material for the Case Studies and Discussion Questions. Appendices D and E will be the subject of the program presentation.

I. *PAST BOND DEFAULTS AND MUNICIPAL BANKRUPTCY.*

A. *Analysis of Past Defaults.*

1. *Municipal Bonds.*

a. Between 1839 and 1969 there were 6,195 recorded defaults of municipal issues.

(1) The defaults between 1839 and 1969 consisted of default by 727 counties and parishes, 1,911 incorporated municipalities, 313 unincorporated municipalities, 1,372 School Districts and 1872 special purpose districts.

(2) During the period of 1929-1937 there were 4,770 defaults by Governmental bodies consisting of the following:

Type of Government Unit	Number in Default	Percentage of Total Number in Default	Indebtedness of Defaulting Unit	Percentage of Debt in Default
Counties	417	13.7	$ 360	15.1
Incorporated municipalities	1,434	8.3	1,760	19.9
Towns and organized townships	88	.4	10	2.9
School districts	1,241	.9	160	7.8
Reclamation, levee, irrigation, and drainage districts	944	28.2		
Other special districts	646	12.4	400	25.0
Total	4,770	2.7	2,690	17.7

<u>See</u>: A Commission Report "City Financial Emergencies: The Intergovernmental Dimension", Advisory Commission on Intergovernmental Relations, Washington, D.C., July, 1973.

b. During the 1930's municipal units defaulted in the payment of interest or principal on some 10% of the then outstanding total of $15 billion of municipal bonds. Between

1945 and 1970 Municipal Bonds in the principal amount of $450,000,000 went into default which constituted .4% of the principal amount of Municipal Bonds outstanding in 1970.

c. Since 1937 when the Municipal Bankruptcy Act was passed, and 1972 there were 362 cases filed.

(1) These 362 cases involved admitted debts of approximately $217,000,000.

(2) In these Chapter IX cases, the amount paid on such debt exceeded $140,000,000 and the amount of loss was approximately $77,000,000.

d. Between 1954-1972, 17 Bankruptcy cases were filed and between 1972 and 1979 there were 9 Chapter IX petitions filed by governmental bodies. Since the effective date of the Bankruptcy Reform Act of 1978 (October 1, 1979) there have been 16 Chapter 9 Petitions filed.

e. In contrast, during the 1940's, there were only 79 defaults by municipalities. However in the 1950's the defaults by municipalities increased to 112 and during the 1960's to 294. As we progress into present economic times, defaults increase.

f. Approximately 75% of all municipal bond defaults have occurred in bonds issued by a municipality to finance revenue producing enterprises (i.e., highways, bridges, utilities, swimming pools, harbors, etc.).

g. Given recent legislative restrictions on taxation combined with economic factors of increasing costs of providing minimal municipal services there is an increasing difficulty posed to municipalities in meeting their debt obligations.

2. *Comparison with Corporate Bonds.*

a. Debt obligation of U.S. corporate business, commercial banks and financial borrowers totaled $112.9 billion in 1965, $346.8 billion in 1977 and estimated to exceed $400 billion in 1981.

b. In years 1900-43 U.S. Corporate Bonds defaulted at an average annual rate of 1.7% of the outstanding; from 1944-65 at an annual average rate of less than 0.10% and after 1965 the annual default rate is gradually rising towards pre-1943 level (See Smith, Barney, Harris, Upham & Co. Corporate Bond Research: Special Report dated April 26, 1978).

c. Present economic conditions including higher interest rates and recent financial troubles of major U.S. Corporations lead some to conclude corporations will and are experiencing difficulties in meeting debt obligations which may pose difficulties for municipal "conduit" financing.

d. The 1984 Annual Report of the Director of the Administrative Office of the U.S. Courts indicates that in fiscal 1984 there were over 20,000 Chapter 11's filed. Bankruptcy has been viewed by some financially troubled corporations as a safe harbor; however, there are seriouis adverse effects to financially troubled municipalities instituting a Chapter 9 proceeding.

B. Probability of Defaults in Corporate and Municipal Bonds.

The 1930's Experience.

1. In 1932 there were in default 1.8% of all municipal bonds, 3.5% of railroad bonds, 5.4% of public utility bonds, 7.2% of industrial bonds and 19.4% of all foreign bonds; thereafter in the 1930's the respective percentages increased. The average default rate for municipal bonds in the 1930's was approximately 10%.

2. Defaults are a function of not only the then economic condition but also the compentence and honesty of the management of obligor and the negative trends in the related industry.

C. Analysis of Defaults Reveal Necessary Changes.

1. It was the defaults in the latter half of the 1800's and early 1900's which brought about the procedures, documents and structuring of municipal financing which are now taken for granted. An analysis of present defaults and the problems

related to defaulted bond issues will lead to the necessary required changes and safeguards.

2. The analysis of past defaults has revealed and caused necessary changes in the documentation for municipal and corporate financing, including:

   a. Debt limitations on municipal issues to prevent excessive borrowing caused by speculative growth in real estate valuations.

   b. Clearly defined bondholders rights in the event of default supported by statutory and case laws.

   c. The use of bond counsel to determine the legality of the bond issue before the sale to avoid technical legal defects which could allow the issuer to repudiate the debt.

   d. The Trust Indenture Act of 1939 (hereinafter referred to as "TIA") specifying needed requirements of providing bondholders in certain issues with an independent Indenture Trustee to protect the rights and interests of the investing public. (However, the TIA is not applicable to municipal bond issues).

   e. Development of credit rating agencies as well as thorough credit review by investment firms and many institutional investors.

   f. Statutory restrictions against municipal issuers borrowing for chronic deficits.

   See H.R. No. 1016, 76th Congress (1939); Section 302 of the TIA; Feldstein, The Daily Bond Buyer, May 12, 1980, pp. 3 and 12.

D. *Present Use of Municipal Bond Financing and Future Needs Require Modification of the Bankruptcy Code.*

1. According to recently released statistics, during the first quarter of 1985, the new issue volume of long-term municipal securities reached $21.9 billion and the short-term volume was $2 billion. Revenue Bond financing has constituted a significant part of this municipal financing since it is an effective means of providing financing of a necessary improvement without obligating the general tax dollar of a municipality.

2. The United States contains the most extensive and sophisticated public work system in the world including 3,866,000 miles of Roadways, 565,000 Bridges, 1,000 Public Mass Transit Systems, 16,000 Airports, 25,000 miles of inland and intra coastal Waterways, 70,000 Dams, 900,000 miles of pipe in Water Supply Systems and 15,000 Waste Water Treatment Plants.

3. Our ability to supply jobs in needed metropolitan areas and our ability to encourage business growth in metropolitan areas will require construction of new public work systems and the continued maintenance and operation of our present public works and infrastructures. The Congressional Budget Office estimates that the cost of meeting, on a nation-wide basis, infrastructure needs will be $1.1 trillion over the next 20 years. Only half of the cost is likely to be provided by the federal government. More dramatic estimates of the infrastructure costs reach almost $3 trillion. Significant increases in infrastructure spending at both the federal and state and local levels are not only inevitable but necessary. Given the condition of our present infrastructure and our needs for continued business growth and increase in jobs, there will be an increasing demand on the Municipal Bond Market to finance these infrastructure improvements over the next 20 years.

4. Financial markets are not static. If there are uncertainties faced by Municipal Bond Investors in purchasing Municipal Bonds due to the interpretation of the present Bankruptcy Code then the Market will begin to question the advisability of such investment. As a result, the Maket may either demonstrate greater selectivity in the obligations purchased or increase the cost of borrowing, both of which would most drastically affect those who most need financing.

E. *Present Financial Condition of Municipalities and the Possible Increased Use of Bankruptcy.*

1. It must be recognized that the economic downturn over the last few years has had an adverse affect on municipal budgets and the ability to fund the needed infrastructure improvements referred to above. Further, over the last 20 years municipalities and metropolitan areas have faced a number of factors which tend to make it more difficult for certain municipalities to be able to meet munici-

pal obligations as they become due. These factors include the following:

a. Movement in both population and manufacturing capabilities from the snowbelt to the sunbelt. (This is due not only to climate but also to the perception of individuals and corporations that there are higher tax levies in certain states).

b. The decline of urban areas and present need in the 1980's for major capital improvements and repairs in many metropolitan areas.

c. Increased percentage of municipal budgets devoted to the cost of personnel and personnel related expenses which for the most part have been tied to cost of living increases which have increased at a higher percentage than tax revenues.

d. The growing unrest among taxpayers in the face of increasing taxation without commensurate increases of benefits. "Proposition 13" mentality is just the beginning of the manifestation which should continue during the 1980's.

e. Adverse effects of inflation which have significantly increased the cost of maintenance, repair and operation of a municipality beyond what was projected at the time the municipal obligations were assumed.

2. A study prepared for the use of the Subcommittee On Economic Goals and Intergovernmental Policies of the Joint Economic Committee of the Congress of the United States captioned "Trends in Fiscal Conditions of Cities 1981-1983" - (S. Prt 98-119, U.S. Printing Office 1983) has outlined the significant difficulties presently facing all cities (small, medium, large and largest). The study surveyed 559 municipalities of which 321 responded and categorized the cities according to the following scale of sizes:

7

Population

1. Small (10,000-49,000-9999)
2. Medium (50,000-99,999)
3. Large (100,000-249,999)
4. Largest (250,000 and over)

3. The study indicated that 43% of the respondents reported current deficits in 1982 as compared to 38% the year earlier. The deficits in proportion to expenditures generally increased while the ratio of the surplus to expenditures declined. The number of cities projecting deficits for 1983 was significantly higher than the number that were actually experiencing deficits in 1982. The largest proportion of cities experiencing operating deficits is in medium cities (47% of these cities reported operating deficits in 1982). These are just the municipalities which will need financing and are least likely to have others come to their aid. In 1982, the increase in expenditures for all cities (8.0%) exceeded the average increase in revenues (6.9%) as well as the rate of inflation (7.1%).

II. *THE HISTORICAL ROOTS OF BANKRUPTCY (CHAPTERS 9 AND 11).*

A. *Bankruptcy as a Mechanism of Debt Adjustment in Greek, Roman and English Common Law.*

1. Principles of Greek Law regarding municipal receiverships and Roman Law regarding discharge of debt and prompt and equitable liquidation of assets.

2. Rigid rules of English Law in 1700 and 1800's.

B. *Constitutional Power of Congress to Enact Bankruptcy Legislation.*

1. The Grant of Power to Congress:

   "Congress shall have Power...to establish...uniform Laws on the subject of Bankruptcies throughout the United States..." U.S. Const., Article I, S8, Clause 4.

2. First National Bankruptcy Act enacted in 1800.

3. Bankruptcy Act of 1898.

4. Bankruptcy Act of 1934 was enacted in an attempt to protect municipalities and corporations from a long series of acrimonious lawsuits injurious to the entity and unproductive in furnishing funds to pay off the creditors.

5. Establishment of Federal Courts to administer Bankruptcy Law. (The Bankruptcy Reform Act of 1978 established a separate and distinct Court whereby the judges would be appointed similar to federal district court judges). However, under Northern Pipeline Construction Co. v. Marathon Pipe Line Company, 458 U.S. 50 (1982) Bankruptcy Court Jurisdiction was limited.

6. Bankruptcy Amendments and Federal Judgeship Act of 1984.

C. *Constitutional Restrictions on Municipal Bankruptcy Law.*

1. In Ashton v. Cameron County Water Improvement District No. 1, 298 U.S. 513 (1936), the Supreme Court held that the recently enacted Bankruptcy Law regarding municipalities (Section 78-80) was unconstitutional in that it infringed upon the sovereign powers of the States (Tenth Amendment) in allowing involuntary bankruptcy petition and interference with fiscal and governmental affairs of a political subdivision. At the time when the Municipal Bankruptcy Act of 1934 was declared unconstitutional there were 89 cases pending.

2. In response to Ashton, Congress enacted Section 81-84 Ch. 657, 50 Stat. 653 (August 16, 1937) of the Bankruptcy Act permitting municipal debt adjustments. Sections 81-84 provides in part for:

   a. No interference with fiscal or governmental affairs of political subdivisions;

   b. Limiting the protection of Bankruptcy to the taxing agency itself;

   c. No involuntary proceedings;

   d. No judicial control or jurisdiction over the property and those revenues of the petitioning agency necessary for essential governmental purpose;

   e. No relief for states in order to avoid impairing of contract obligations by states which is constitutionally prohibited.

Sections 81-84 of the Bankruptcy Act were held by the U.S. Supreme Court to be constitutional in United States v. Bekins, 304 U.S. 27 (1938).

3. The Municipal Bankruptcy Act was amended in 1946 to repeal the expiration date provided in the law (Section 84), to make Chapter IX a permanent part of the Bankruptcy Act and to amend Sections 81, 82 and 83 as follows:

   a. Extend the benefits of Chapter IX of the Bankruptcy Act to securities issued by "incorporated authorities, commissions or other similar public agencies organized for the purpose of constructing, maintaining or operating revenue-producing enterprises".

   b. Provide for references of special issues of fact to a referee in bankruptcy or special master for a report and finding of specific facts.

   c. Provide for a preliminary stay of proceedings against a municipal agency upon the filing of a proceeding under Chapter IX for a composition of its indebtedness.

   d. Strengthening the effectiveness and workability of Chapter IX by means of certain procedural changes.

   See Report of the House Committee on the Judiciary on H.R. 6682 amending Sections 81-84 of the Bankruptcy Act, H.R. Rep. No. 2246, 79th Congress, 2nd Session (1946).

D. *Municipal Debt Adjustment (Chapter 9 Under the Bankruptcy Reform Act of 1978) and Alternatives to Municipal Bankruptcy.*

1. A Chapter 9 proceeding is a mechanism for municipalities through a Court supervised proceeding to attempt to settle disputes between the Debtor municipality and a majority of its creditors. One of the stated purposes of the Bankruptcy Reform Act of 1978 was to provide a "workable procedure so that a municipality of any size that has encountered financial difficulty may work with its creditors to adjust its debts". 1978 U.S. Code Administrative News 6221.

2. A Chapter 9 proceeding is a means of debt adjustment not elimination of debts. Generally, Municipal Debt Adjustment has meant that Bondholders have been paid principal and interest but over a larger period of time. There generally has not been a drastic reduction or forgiveness of principal amount of the Bonds.

3. Numerous states have statutes which provide for a State Receiver or State Agency to act as a receiver when a local government unit defaults on its financial obligations. Some states have statutes granting State Courts varying degress of responsibilities over any municipal unit that experiences a financial collapse. Some States have no specific statutory mechanism for State responsibility if a municipality or municipal unit cannot meet its financial obligations.

4. In some states, taxpayers or Bondholders may seek the revocation of the municipal charter and request that the State Court supervise liquidation of the municipal assets.

III. ANALYSIS OF CHAPTERS 7, 9 AND 11 OF THE BANKRUPTCY REFORM ACT OF 1978.

In response to the difficulties which corporations and municipalities were experiencing in the 1960's and early 1970's and the inability of the Bankruptcy Act to meet all of the expected needs of corporate debtors and municipal bodies in obtaining an effective reorganization of corporate debt or adjustment of municipal debt, Congress, as part of the Bankruptcy Reform Act of 1978 (the Bankruptcy Code), has specifically amended and modified Chapters VII, IX and XI and created new Chapters 7, 9 and 11 to deal with municipal debt adjustments, corporate reorganization and Bankruptcy liquidation. Since the party ultimately responsible for payment of the Bonds in a "conduit municipal financing" is a private corporation, this analysis will include an analysis of Chapters 7 and 11 of the Bankruptcy Code which relate to private corporations. All citations, unless otherwise indicated, are to the Bankruptcy Code, 11 U.S.C. S101 et seq.

A. *Municipal Debt Adjustment (Chapter 9) and Corporate or Individual Business Reorganization (Chapter 11) or Business Liquidation (Chapter 7) and the Effect of Such on Bondholder Rights and Remedies.*

1. *Initiation of Chapter 7, 9 and 11 Proceedings.*

a. Chapter 9 Filing by a Municipality.

(1) Only a municipality may be a debtor under Chapter 9 [S109(C)(1)] and only a municipality may file a petition under Chapter 9 (S301). Creditors of a municipality cannot institute involuntary proceedings. [See SS303 and 901(a)].

(2) Chapter 9 is the exclusive chapter under which municipalities can file. Chapter 7 and 11 are not available because municipalities are not "debtors" under such chapters. (See S301 which provides that a petition may be filed under a particular chapter only by a person or entity which qualifies as a "debtor" under such chapter; SS109(b) and 109(d) which provide that only "persons" may be debtors under Chapters 7 and 11; and S101(30) which defines "person" to include and individual, a partnership or a corporation, but not a governmental unit.)

(3) A municipality is a "political subdivision or public agency or instrumentality of a state". [S901(29)].

(4) Before the municipality is able to institute a proceeding under Chapter 9 of the Bankruptcy Code, it must be generally authorized to be a debtor under such Chapter by state law or by a governmental officer or organization empowered by state law to authorize such entity to be a debtor under such Chapter. [S109(c)(2)].

(5) In order to be eligible to institute a proceeding under Chapter 9 a municipality must be able to demonstrate that:

(a) It is insolvent or unable to meet such entity's debt as the debts mature and desires to perfect a plan to adjust such debts. [S109(c)(3) and (4)]

(b) One of the following has occurred:

(i) The municipality has obtained the agreement of creditors holding at least a majority in the amount of claims of each class that such entity intends to impair under a plan in a case under such Chapter;

(ii) The municipality has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in the amount of claims of each class that such entity intends to impair under a plan in a case under such Chapter;

(iii) The municipality is unable to negotiate with creditors because such negotiations are impractical;

(iv) The municipality reasonably believes that a creditor may attempt to obtain a preference. [§109(c)(5)]; or

(v) With regard to an unincorporated tax or special assessment district which does not have its own officials an action is commenced under Chapter 9 by filing a petition under that Chapter by such district's governing authority or board or

body which has the authority to levy taxes or assessments to meet the obligations of such district. [See §921(a)];

(vi) Home rule power granted to a municipal body may be sufficient authorization to be eligible to institute a Chapter 9 proceeding even though there is no expressed power statutorily to file a bankruptcy petition. See In re Pleasant View Utility District of Cheatham County, Texas, 24 B.R. 632 (M.D. Tenn. 1982) ["Power of municipality to sue and be sued" held sufficient to authorize municipality to file]. But see unpublished opinion in In re North and South Shenango Joint Municipal Authority, (W.D. Pa. 1981).

(vii) A number of State Statutes are silent on the issue of whether local governmetal bodies are authorized to file under Chapter 9. However, some states have specifically prohibited municipalities from filing under the Federal Bankruptcy Code. [See, e.g. §36-80-5 of Official Code of the State of Georgia].

b. Filing Under Chapter 7 (Liquidation) or 11 (Reorganization).

(1) A Chapter 7 or 11 proceeding may be instituted by the Debtor (voluntary)

or by a holder of a claim (involuntary) provided no involuntary petition may be filed against a farmer or a corporation that is not a moneyed, business or commercial corporation (not for profit corporation). [See §§301 and 303]

(2) Creditors may institute a Chapter 7 or 11 involuntary proceeding under Section 303. Three creditors holding claims against debtor, not contingent as to liability, in the aggregate value in excess of $5,000, may file a petition if debtor against whom order of relief is sought is a person or entity entitled to benefits under Chapter 7 or 11.

c. Dismissal of Petition.

(1) If it can be shown to the Bankruptcy Court that a petition was filed by a municipality not in good faith or not meeting the requirements of Chapter 9, the petition may be dismissed. [§921(c)]

(2) If a debtor in Chapter 11 proceedings continues a loss or diminution of the estate with an absence of a reasonable likelihood of rehabilitation or if a debtor is unable to effectuate a plan or delays unreasonably in formulating a plan, a Chapter 11 proceeding may be dismissed. Generally, the Court may dismiss or convert to a case under Chapter 7 (liquidation) for any grounds which are in the best interest of the creditors and the estate. [§1112(c)]

2. *Limitation on Jurisdiction and Powers of the Bankruptcy Court (Federal and State Relationship).*

a. Given the prohibitions placed upon Congress by the U.S. Constitution, Chapter 9 does not grant the Bankruptcy Court the power to interfere with governmental affairs of the municipal body. [See Ashton v. Cameron County Water Improvement District No. 1, 298 U.S. 513 (1936) and United States v. Bekins, 304 U.S. 27 (1938)].

b. Section 904 of the Bankruptcy Code specifically provides that the Court may not, unless the municipality consents or its plan so provides, interfere with:

(1) Any governmental or political powers of the municipality;

(2) Any property or revenues of a municipality;

(3) The municipality's use or enjoyment of any income producing property.

c. In a recent decision, the U.S. Supreme Court held that the broad grant of jurisdiction to bankruptcy judges contained in the Bankruptcy Reform Act of 1978 violates Article III of the U.S. Constitution which provides that the judicial power of the United States must be exercised by judges who have the attributes of life tenure and protection against salary diminution. Northern Pipeline Construction Co. v. Marathon Pipeline Co., 458 U.S. 50 (1982). Congress adopted the Bankruptcy Amendments and Federal Judgeship Act, which was signed into law on July 10, 1984, in response to the Northern Pipeline case. In the recent bill, which is discussed in detail in Section III below, Congress did not create Article III bankruptcy courts. Rather, Congress legislated that bankruptcy judges shall constitute an arm of the federal district courts to be known as the bankruptcy court. The Bankruptcy Judges, who may hear certain types of matters which are referred to them are appointed by the Courts of Appeals. Certain provisions of this new bill have been upheld in In re Benny, 12 B.C.D. (N.D. Cal. 1984); see also Wasatch Factoring, Inc., Misc. No. B-0015W (D. Utah, Nov. 26, 1984 (oral opinion); In re Tom Carter Enterprises, Br. No. SA-83-05401 R.P. and No. SA-84-0624 R.P. Slip. Op. Cal., Dec. 7, 1984).

3. *The Automatic Stay.*

a. The filing of a petition under Chapter 9 or 11 operates as an automatic stay of any action to collect a debt from debtor, create

a lien on debtor's property, or take possession of debtor's property. [SS362(a)(1) and 922(a)(1)]

b. For municipalities, the automatic stay includes: (S922)

(1) The commencement or continuation, including the issuance or employment of process, of judicial, administrative, or other proceeding against an officer or inhabitant of the debtor that seeks to enforce a claim against the debtor;

(2) The enforcement of a lien on or arising out of taxes or assessments owed to the debtor.

c. For debtors in a Chapter 11 proceeding, the automatic stay includes: [S362(a)]

(1) The commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other proceeding against the Debtor...or to recover a claim against the debtor that arose before the commencement of the case...;

(2) The enforcement, against the debtor or against the property of the estate, of a judgment before the commencement of the case;

(3) Any act to create, perfect or enforce any lien against property of the estate;

(4) Any act to collect, assess or recover a claim against the debtor, or to set off any debt owing to debtor that arose before the commencement of the case; and

(5) Any act to obtain possession of property of the estate.

d. Special Treatment in Railroad Reorganizations.

There is an exception to the automatic stay for liens on rolling stock equipment in a "Railroad Reorganization". [S1168] However, the word "railroad" may be argued to be defined broadly so that it may include a public body acting as a "common carrier" or as lessor of the tracks [See S101(33)]. Section 1168 is not made applicable to the municipal bankruptcies under S901(a).

e. Termination or Modification of Stay.

(1) A creditor may petition the court for relief from the automatic stay and after notice and hearing the court may either continue, modify, condition, or terminate the stay. [S362(d) and (e)]

(2) The court shall grant relief from the stay:

(a) for cause, including lack of adequate protection of an interest in property of the plaintiff, or

(b) with respect to a stay of an act against property.

(i) debtor does not have an equity in the property, and

(ii) the property is not necessary to an effective reorganization. [S362(d)(1)]

(3) Stay terminates 30 days after creditor files complaint seeking relief from stay unless court orders stay continued in effect pending a final hearing and a determination under S362(d).

(4) For Cause, Including Lack of Adequate Protection. Adequate protection is not defined in the Code but examples are given in Section 361:

cash payments as necessary to compensate for any decrease in value; giving additional or replacement lien to compensate for a decrease in value; or any other means which will result in the realization of the indubitable equivalent of the creditor's interest in such property.

(a) Adequate Protection--means cash compensation for a decrease in value of an interest in property by means of cash payments or substitution of another lien or other means which will result in the indubitable equivalent. (S361 of the Bankruptcy Code) To the extent adequate protection of the interest of the holder of a claim proves to be inadequate then the creditor's claim may be given a priority over every other allowed unsecured, general claim as an administrative expense entitled to distribution under S507(a) of the Bankruptcy Code. However, under S901(a) of the Bankruptcy Code, S507(b) does not apply to Chapter 9. Section 507(b) is the Section which would grant in corporate debt bankruptcy (conduit municipal financing) a superpriority claim as a superior administrative expense.

(b) Protection of the Interest in Property, not the Underlying Debt. The requirement of adequate protection seeks to ensure that while a creditor's remedies may be suspended or abrogated, the value of its secured position as it existed at the commencement of the case is to be protected throughout the case. The interest to be protected by S362(d)(1) is the creditor's interest in the property, which is measured by the

value of the lien, not by the amount of the debt. In re Alyucan Interstate Corp., 12 B.R. 803 (D. Utah 1981). Hence, protection extends only to a creditor's "allowed secured claim" and not to any unsecured part of a claim. In re BBT, 11 B.R. 224 (D. Nev. 1981); In re Nixon Machinery Co., 9 B.R. 316 (E.D. Tenn. 1981).

(c) Valuation. Courts have focused on valuation of the property not only because the interest to be protected is the value of the lien on such property but also because this result is implicit in S361's first two examples of adequate protection. Subsection (1) provides for periodic cash payments to the creditor while subsection (2) provides for additional or replacement liens "...to the extent that the stay...results in a decrease in the value..." of the creditor's interest in the property. In placing a value upon real property, some Bankruptcy Courts have considered the highest and best use of such property. This results, for example, in evaluating the property as a residential subdivision rather than raw land. The court used the "developmental" or "land residual" approach under which the sales value of the lots less costs of development and sales as well as a reasonable profit determined the actual value of the land in its present, undeveloped state. In re San Clemente Estates, 5 B.R. 605 (S.D.Cal. 1980). But compare In re El Patio, Ltd., 6 B.R. 518 (D.C.Cal. 1980) in which the Bankruptcy Court refused to evaluate the real

estate in question as condominiums, but rather as apartments since the debtor's right to convert to condominiums had not yet been established as a result of a legal dispute with the Santa Monica Permanent Rent Control Board.

(d) Equity Cushion. A sufficient "equity cushion" existing between the amount of the indebtedness owed and the value of the property securing such indebtedness may, without more, provide the creditor adequate protection against decrease in value during the automatic stay. In re San Clemente, supra; In re Gaslight Village Inc., 8 B.R. 866 (D.Conn. 1981); In re Rogers Development Corp., 2 B.R. 679 (E.D.Va. 1980), In re Pitts, 2 B.R. 476 (C.D.Cal. 1979); In re Nixon Machinery Company, supra; In re Orlando Coals, Inc., 6 B.R. 721 (W.D.Va. 1981). Some courts have taken into account the costs of foreclosure and sale in arriving at the amount of the equity cushion. In re Pitts, supra; In re Bailey, 11 B.R. 181 (E.D.Va. 1981). Where an insufficient equity cushion or none at all exists, and the debtor has provided no other means of adequate protection, the request for relief from the stay will be granted. See In re Santoro, 12 B.R. 36 (S.D. Fla. 1981); In re Sundale, 11 B.R. 978 (S.D. Fla. 1981); In re Bailey, supra; In re Thomas Parker Enterprises, Inc., 10 B.R. 783 (D.Conn. 1981); In re Tucker, 5 B.R. 180 (S.D.N.Y. 1980). Courts have been reluctant to set standards or a rule of thumb as to just what constitutes a "sufficient" equity

cushion, instead applying equitable considerations to the facts and circumstances of each cash. In re San Clemente, supra. In the case of conduit municipal financing where the Bondholders have a mortgaged interest in real estate as collateral for Bond payments the equity cushion may be demanded by the Bondholders. See In the Matter of Lake Tahoe Land Co., 5 B.R. 34 (D.Nev. 1980) [equity cushion of 40-50% required]; In re Fraine, 9 B.R. 439 (M.D. Fla. 1981) [equity cushion of 12.4% inadequate]; In re Tucker, 5 B.R. 180 (S.D.N.Y. 1980)[equity cushion of 7.4% inadequate].

(e) No Decrease in Property's Value. Where there is no evidence that the value of the property is declining during the automatic stay, this alone may prevent relief from the stay, even where the equity cushion is minimal. In re El Patio, supra; In re BBT, supra; In re Wolford Enterprises, Inc., 11 B.R. 571 (S.D.W. Va. 1981); Matter of Mulcahy, 5 B.R. 558 (D.Conn. 1980).

(f) Cash Payments Approximating Depreciation. Periodic cash payments to the creditor, as necessary to compensate for any decrease in value of the property during the stay have been held to provide adequate protection, as contemplated by §361. In re Kors, Inc., 11 B.R. 324 (D.Vt. 1981); In re Nixon Machinery Company, supra; In re 5-Leaf Clover Corp., 6 B.R. 463 (S.D.W.Va. 1980). An order to continue the automatic stay can be predicated on the making of such payments so that

upon default of any such payment, the stay is lifted as of the date of the default. In re Kors, Inc., supra. In a Central District of California Bankruptcy Court case, the court awarded 2% per annum on the amount of the secured claim as "equitable compensation" to the creditor during the stay, which was the equivalent of compensating the creditor for depreciation of his interest in the property. In re El Patio, supra. In a mortgage or lease financing for Industrial Revenue Bond Issue Bondholders should consider requesting cost payment of adequate protection or use and occupancy. [S361 and 506(c)]

(g) Payment of Monthly Mortgage and Arrearages. The payment of amounts due under the mortgage, trust deed, or other contract plus a portion of arrearages may constitute adequate protection. In re Roane, 8 B.R. 997 (E.D.Pa. 1981); In re Pannell, 12 B.R. 51 (E.D.Pa. 1981); In re Sombrero Reef Club, Inc., 7 B.R. 480 (S.D.Fla. 1980); In re Stuart Motel, Inc., 8 B.R. 50 (S.D.Fla. 1980).

(h) Payment of Taxes, Interest, Insurance. Where value of the property will not decrease during the period of the automatic stay, adequate protection is provided by payment of taxes and insurance. In re El Patio, supra; In re BBT, supra; In re Graydon, 8 B.R. 475 (S.D.Fla. 1981).

(i) Payment of Interest on Value of Collateral. Although a court held that interest is allowed on a secured claim

under §506(b) to the extent that the collateral has a value greater than the amount of the claim and that therefore interest is not allowed on undersecured claims, it found that the debtor's offer to pay interest in the latter situation constituted adequate protection. In re American Mariner, 10 B.R. 711 (C.D.Cal. 1981).

(j) Liens on Other Assets. Adequate protection may consist of providing additional security in the form of liens on other assets of the debtor.

(k) Equitable Considerations. As a court of equity, the bankruptcy court is required to consider the impact of the automatic stay on the parties and to consider the "balance of hurt" in fashioning relief. In re El Patio, supra; In re San Clemente Estates, supra; In re Presock, 9 B.R. 676 (E.D.Pa. 1981); In re Britton, 9 B.R. 245 (E.D.Pa. 1981).

(l) "For Cause" Other than Lack of Adequate Protection. It has been held that the debtor's lack of good faith in filing a case under Chapter 11 is "cause," independent of the existence or lack of adequate protection, to vacate an automatic stay where the debtor was attempting to use the provisions of Chapter 11 to create and organize a new business, not to reorganize or rehabilitate an existing enterprise. In re Victory Construction Co., 9 B.R. 549 (C.D.Cal. 1981).

(m) "Indubitable Equivalent." No case expressly depends on §361's third alternative for finding adequate protection

on the basis of providing the "indubitable equivalent" of the creditor's interest in secured property. Occasionally courts have found that the creditor has or has not been provided the indubitable equivalent of his interest in the property, but have done so without elaboration and only as an additional basis for finding that adequate protection has or has not been provided.

(5) No Equity and Not Necessary for Effective Reorganization.

The other ground for relief from the stay provided in S362(d), which applies only to the stay of an act against property, is lack of equity in the property accompanied by a lack of need for the property for an effective reorganization.

(a) Reorganization Cases. This alternative is often of little practical value to creditors in reorganization cases since in most cases the property will be needed for an effective reorganization. The reference to an "effective" reorganization requires relief from the stay if there is no reasonable possibility of a successful reorganization within a reasonable time. In re Thomas Parker Enterprises, Inc., supra; In re Clark Technical Associates, Ltd., 9 B.R. 738 (D.Conn. 1981); In re Gilece, 7 B.R. 473 (E.D.Pa. 1980); In re Stewart, 11 B.R. 93 (N.D.Ga. 1981); In re Tucker, 5 B.R. 180 (S.D.N.Y. 1980).

(b) Liquidation Cases. The lack of equity test is most relevant in liquidation cases where a rehabilitation is not being

sought and where, if there is no equity to be realized for junior interests, there is no reason to continue the stay. See In re Bailey, 11 B.R. 199 (E.D.Va. 1981).

4. *Debtor's Use of, Sale, or Lease of Property (Section 363).*

a. Section 363 gives the debtor in possession or the trustee the power to use, sell, or lease property of the estate in the ordinary course of business without notice or hearing except if such property constitutes "cash collateral." The use, sale, or lease of cash collateral requires either the consent of the entity having an interest therein, or court authorization. The use, sale or lease of estate property other than in the ordinary course of business also requires consent or court authorization. Section 363 does not apply to a Chapter 9 proceeding but would be applicable to a private corporation in a conduit municipal financing.

b. Sale can be subject to or free of existing liens. Use may cause depreciation of the collateral. Where the collateral is cash, its use may be tantamount to consumption unless it is used to purchase other property having equal value. What safeguards are afforded the creditor with an interest in such property?

(1) Adequate Protection. The court must condition or prohibit the debtor's use, sale or lease of property, at the request of an entity with an interest therein, as necessary to adequately protect the requesting entity. [§362(e)] "Adequate protection" has the same meaning as in hearing on relief from automatic stay. (See §361) The most common form of adequate protection is for the interest to attach to the proceeds of the sale.

(2) Cash Collateral. The debtor has the burden of proving that his use of cash collateral will be such that adequate protection is provided to the

creditor's interest in the property. Section 363(c)(4) provides that the debtor is required to segregate and account for any cash collateral in the debtor's possession.

(3) Sales Free of Liens. Such sales can occur only if one of five situations exists: Applicable nonbankruptcy law would permit a sale of such property free of the interest; the entity with the interest consents; the interest is a lien and the sales price is greater than the aggregate value of the lien; the interest is in bona fide dispute; or the entity could be compelled in a legal or equitable proceeding to accept a money satisfaction of such interest.

(4) Ipso Facto Clauses. An attempt to terminate or modify the debtor's interest in property of the estate by use of ipso facto clauses will not prevent the debtor's use, sale or lease of property pursuant to S363. [S363(1)]

5. *Notice, List of Creditors and Proof of Claim.*

a. Notice of Chapter 9 Proceeding. A notice must be given of commencement of the case under Chapter 9, an order for relief under Chapter 9 and any dismissal of the case under Chapter 9. Such notice must be published once a week for three successive weeks in at least one newspaper of general circulation published in the district in which the case is commenced and in such newspapers having general circulation among bond dealers and bondholders as the Court designates. [S923].

b. List of Creditors. In order to vote on any plan of adjustment (Chapter 9) or plan of reorganization (Chapter 11) and to be counted as a creditor, a party who has a claim against the debtor must either file a proof of claim under S501 or be listed as a creditor in the list of creditors filed by the debtor under SS521(1) and 924. Pursuant to SS925 and 1111(a) any claim that appears in a list of creditors filed by the debtor in the

Chapter 9 or 11 proceedings, respectively, will be deemed to be a filed proof of claim under S501 "except a claim that is listed as disputed, contingent or unliquidated."

6. *Obtaining Credit in a Chapter 9 or 11 Proceeding.*

a. Unsecured Credit. Unless the court orders otherwise, a debtor may obtain unsecured credit and incur unsecured debt in the ordinary course of its business, allowable as an administrative expense under S503(b). [S364(a) and (b)]

b. Secured Credit. If the debtor is unable to obtain unsecured credit allowable under S503(b)(1) as an administrative expense, the court, after notice and hearing, may authorize the obtaining of credit or the incurring of debt:

(1) With priority over all administrative expenses of the kind specified in S503(b) or S507(b).

(2) Secured by a lien on property of the estate that is not otherwise subject to a lien;

(3) Secured by a junior lien on property of the estate that is subject to a lien; or

(4) Obtain credit secured by a lien equal to or senior to that of a prior lien on the property of the estate under certain circumstances. [SS364(a), (b), (c) and (d)].

7. *Assumption, Rejection, or Assignment of Executory Contracts and Unexpired Leases.*

a. Assumption or Rejection The municipality or corporate debtor subject to Court approval may assume or reject an executory contract or unexpired lease of the respective municipality or corporate debtor subject to certain specific provisions of the Bankruptcy Code (S365 of the Bankruptcy Code). As set forth below, provisions regarding the rejection of corporate collective bargaining agreements are contained in the recent amendments to the Bankruptcy Code.

b. Defining Executory Contracts. The Code does not define "executory contract." Legislative history (H.R.Rep. 95-595, 95th Cong., 1st Sess. 347 (1977) and S.Rep. No. 95-989, reprinted in, [1977], U.S. Code Cong. and Ad. News 5787-5844) suggests that executory contracts are those in which performance remains due to some extent on both sides. A refinement of this definition, adopted by the Ninth Circuit Court of Appeals and several bankruptcy courts in various jurisdictions, states that an executory contract within the meaning of the code is any contract under which the obligation of both the bankrupt and the other party are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other. In re Alexander, 670 F.2d 885,887 (9th Cir. 1982); In re Select-a-Seat Corp., 625 F.2d 290 (9th Cir. 1980); In re Fashion Two Twenty, Inc., 16 B.R. 784 (D. Ohio 1981); In re Sun Ray Bakery, Inc., 5 B.R. 670 (D. Mass. 1980). Under this view, notes, bonds and contracts under which the only outstanding obligation is repayment, on the one side, and some ministerial act (such as surrender of the note or cancellation of a lien) on the other do not constitute executory contracts. See In re Whatley, 16 B.R. 394 (D.Ohio 1982) and In re Sholos, 11 B.R. 782 (D.Pa. 1981).

c. Bankruptcy "Ipso Facto" Clauses are Unenforceable. Clauses terminating or modifying an executory contract or unexpired lease or any right or obligation under such contract or lease on account of insolvency or bankruptcy are unenforceable in bankruptcy. This includes clauses that accelerate the payment of obligations in the event of insolvency or bankruptcy.

d. Curing Default in Executory Contract or Unexpired Lease. If a municipality or corporate debtor desires to assume such an executory contract or unexpired lease, it must cure any default that may exist except for defaults which are caused by reason of the institution of the bankruptcy proceeding or the financial condition of the

debtor at the time of the pendency of the bankruptcy proceeding. See S365(b) of the Bankruptcy Code. If the municipality or corporate debtor decides not to cure the existing default, the municipality or corporate debtor may still assume the executory contract or unexpired lease if it provides adequate assurance that any such defaults will be promptly cured and provides adequate assurance that future performance under the contract or lease will be complied with. [S365(b)(1)(B) and (C)] A corporate debtor must assume or reject an unexpired lease of nonresidential real property under which the debtor is the lessee within 60 days after the order for relief or within such additional time as the Court shall fix or the lease shall be deemed rejected and the nonresidential real property surrendered to the landlord. [S365(d)(4)]

e. Adequate Assurance. Adequate assurance has a specific definition with regard to real estate in a shopping center but as to executory contracts and other leases there is no specific provision in the Bankruptcy Code defining its precise meaning. (S365(b)(3) of the Bankruptcy Code) The terms "adequate asurance of future performance" are not words of art, but were intended to be given a practical, pragmatic construction. What constitutes adequate assurance is to be determined by factual conditions. In re Lafayette Radio Electronics Corp., 9 B.R. 993, 998 (N.Y. 1981); In re Sapolin Paints, Inc., 5 B.R. 412, 420-21 (E.D.N.Y. 1980); In re Luce Industries, Inc., 8 B.R. 100, 104 (S.D.N.Y. 1980).

f. Time for Assumption or Rejection. A Chapter 9 or 11 debtor may assume or reject an executory contract or unexpired lease at any time before confirmation of the plan, except that, upon request, the Court may order the debtor to determine within a specified period of time whether to assume or reject. [S365(d)(2)] In a Chapter 7 proceeding if a trustee does not assume or reject an executory contract or unexpired lease of the debtor within 60 days after the order for relief or such additional time as the court may so fix, such contract or lease is deemed rejected. [S365(d)(1)]

g. Municipality or Debtor May Assign Executory Contracts or Unexpired Leases. [S365(f)]. Covenants against assignment are unenforceable as against an attempted assignment by the debtor. [S365(f)(1)] Assignment relieves the debtor of liability for any future breach occurring after assignment. [S365(k)] In order to assign, debtor must first assume the contract or lease, cure existing defaults and establish adequate assurance of future performance by the assignee. [S365(f)(2)]

h. Contracts to Borrow Money Not Assumable or Assignable. Debtor may not assume or assign an executory contract to borrow money, for debt or equity financing or for financial accommodations to or for the benefit of debtor. [S365(c)]

i. Rejection of Contract or Lease as a Breach. The rejection of an executory contract or an unexpired lease by a municipality constitutes a breach of such contract or lease under certain circumstances including if such contract or lease has not been assumed prior to the commencement of a proceeding or under a plan confirmed under Chapter 9. [See S365(g)]

8. *Ability of Municipality or Corporate Debtor to Set Aside Transfers and Liens.*

a. "Strong Arm" Power. Debtor can avoid transfers (including transfers of security interests) that would be avoidable by either an actual unsecured creditor of the debtor or a hypothetical creditor who has a status that has been referred to as that of an "ideal lien creditor." [S544]

b. Statutory Liens. Any statutory liens (such as mechanics', warehouseman's, tax liens) which can be placed on debtor's property after commencement of a proceeding under Chapters 9 or 11 can be avoided if (1) such is triggered upon commencement of a proceeding; (2) it is not perfected or enforceable on the date of filing a petition; (3) it is for rent; or (4) a lien of distress for rent. [S545]

c. Preferences. Debtor may avoid any transfer (including a transfer of a security interest) made to or for a creditor on account of an antecedent debt within 90 days before the filing of the petition, if such transfer would give the creditor more than he would otherwise have received in liquidation of the bankrupt estate under Chapter 7. The preference period is extended to 1 year if the creditor was an "insider".

(1) However, a voidable preference does not occur if the transaction was intended and in fact was a substantially contemporaneous exchange for new value given to the debtor. [SS547(c)(1), (c)(3) and (c)(4)]

(2) A voidable preference does not occur if transfer was in payment of debt incurred in ordinary course of business or financial affairs of the debtor and the transferee not later than 45 days after such debt was incurred. [S547(c)(2)]

(3) A voidable preference does not occur upon transfer of a perfected security interest in inventory or receivables except to the extent of any net reduction in the excess of the secured claim over the value of the security. [S547(c)(5)]

d. Fraudulent Transfers. Debtor may avoid fraudulent transfers made within 1 year before the filing of the petition. [S548]

e. Post-Petition Transfers. Debtor may avoid transfers made after the commencement of the case, including payment of antecedent debt. [S549(a)]

f. Post-Petition Acquisitions. Similarly, property acquired by the debtor after commencement of the case is not subject to any lien resulting from any security agreement entered into prior to commencement of the case. [S552(a)] Exception: if it is included in the security agreement as "proceeds, product, offspring, rents, or profits" of property covered by the security agreement

before commencement of the case. [S552(b)]

g. Limitation on Avoiding Powers. Any action to avoid transfers under SS544, 545, 547, 548 or 553 must be commenced within specified period of time (generally, may not be commenced after the earlier of two years after appointment of trustee or the time case is closed or dismissed). [S546(a)] The avoiding powers under SS544, 545 and 549 are subject to general applicable law that permits "perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of such perfection" and "are subject to statutory or common law right of the seller of goods in the ordinary course of such seller's business to reclaim such goods" under certain circumstances. [S546(b) and (c)]

9. *Post-Petition Interest.* An allowable claim does not include unmatured interest. [S502(b)(2)] To the extent an allowed claim is secured by property the value of which is greater than the amount of such claim, interest (together with any reasonable fees, costs or charges provided under the agreement under which the claim arose) will be allowed. It can be argued that a pledge of revenue of a municipality sufficient to pay principal, interest and expenses both pre and post-petition should be allowed and paid.

10. *The Question of Whether Certain Liens or Pledges Granted by The Municipality or Corporate Debtor Are Terminated Upon The Filing of a Petition.*

a. Section 552(a) provides that property acquired by the municipality or corporate debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the municipality or corporate debtor prior to the commencement of the case.

b. Revenue bonds are secured by the pledge of revenues flowing from tax levies or assessments to be received from the respective taxpayers. Some may argue that upon the filing of a petition under Chapter 9 such security interest ceases since the taxes paid after the filing of the petition are property

acquired by the municipality after the commencement of the case.

c. It may be argued that just like the case of a security interest created by a security agreement which "extends to property of a debtor acquired before the commencement of a case and to the proceeds, product, offspring, rents or profits of such property" the pledge of municipal revenues creates security interest under §552(b) of the Bankruptcy Code which continues after the commencement of the case. A pledge of the revenue created by resolution or ordinance should continue after the commencement of the case under applicable state law and policy.

11. ***Setoffs.*** A creditor may offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case against a claim of such creditor against the debtor that arose before the commencement of the case. [§553(a)]

a. Mutual Debts. Although not defined in the Code, the term "mutual debt" has been construed to mean that debts are in the same right and between the same parties standing in the same capacity. 4 Collier, Bankruptcy ¶553.04[3] at 553-22 (15th ed. 1979); In re Visiting Home Services, Inc., 643 F.2d 1356, 1361 (9th Cir. 1981); In re 18th Avenue Development Corp., 12 B.R. 10, 11-12 (S.D.Fla. 1981).

b. Restrictions on Setoff.

(1) Section 553(a) prohibits the setoff of claims against the debtor that were transferred to the creditor by an entity other than the debtor, either after the commencement of the case or during the 90 days preceding the petition while the debtor was insolvent. (Under §553(c), the debtor is presumed to be insolvent during the 90 days immediately preceding the filing of the petition).

(2) Section 553(a)(3) restricts the setoff of a debt owed to the debtor by a creditor that was incurred within 90

days before the filing of the petition while the debtor was insolvent for the purpose of obtaining a right of setoff against the debtor. This provision is intended to discourage the practice by which a debtor increases its deposits in its account with a lender bank for the purpose of preferring the bank over other creditors. By this practice, the lender bank becomes indebted to the debtor through the receipt of deposits. (See "Setoff under the Bankruptcy Code," Cook, Kass and Santoro, 2nd Annual Bankruptcy Litigation Institute, pp. 158-172, 1982).

(3) Section 553(b) provides that any increase in the 90 days before bankruptcy in the amount of the debt owing by the creditor to the debtor will not be permitted to be offset.

12. *Plan of Adjustment for Municipalities (Chapter 9) or Reorganization (Chapter 11).*

a. Time for Filing.

(1) Municipality shall file a plan of adjustment of its debt either with the petition or at such later date as the Court may fix. (S941) Municipality may modify the plan at any time prior to confirmation provided such modification is consistent with the requirements of Chapter 9. (S942)

(2) Debtor in Chapter 11 proceeding has the exclusive right to file a plan until 120 days after the date of the order for relief (involuntary) or the filing of the petition (voluntary) or such longer or shorter period as the court may set. Thereafter, any party in interest may file plan. If the Debtor has filed a Plan within the 120 day period but the Plan is not accepted within 180 days of the date of filing the Petition or the Order for relief (or such long or shorter time as the Court may set) then any party in interest may file a Plan (S1121).

b. <u>Content of Plan.</u>

(1) The plan may provide, among other things, for sale of property of the estate, either subject to or free of any lien; cancellation or modification of any indenture or similar instrument; extension of a maturity date or a change in an interest rate or other term of outstanding securities; or issuance of securities of the debtor for existing securities; and may impair any class of claims, secured or unsecured. [SS1123(a) and (b)]

(2) The plan shall include the following

(a) Designation of the classes of claims that exist specifying any class of claim or interest that is not impaired under the plan.

(b) Statement of the treatment of any class of claims or interests that is impaired under the plan.

(c) Statement providing for the same treatment for each claim or interest or a particular class unless the holder of a particular claim or interest agrees to a less favorable treatment of such claim or interest.

(d) Statement of a means for the execution of the plan such as the sale of property, transfer of property, the satisfaction or modification of any lien, the cancellation or modification of any indenture or similar instrument, the curing or waiving of default, extension of a maturity date, the change of interest rate or other terms of outstanding securities, or the issuance of new securities.

(e) Statement, if appropriate, of the settlement or determination of any disputes between parties.

(f) Assumption or rejection of any executory contracts or unexpired leases.

[§1123(a) and (b)]

c. Impairment of claim or interest. A claim or interest is impaired under the plan unless:

(1) It remains unaltered as to its legal, equitable, contractual rights;

(2) Any default which caused the acceleration of the indebtedness is cured; and in addition:

(a) The original maturity of such claim or interest is reinstated as such maturity date existed before the default; and

(b) Any damages suffered to the holder of such claim or interest as a result of reasonable reliance by such holder on such contractual provisions or such applicable law is appropriately compensated; and

(c) After curing the default the equitable, legal and contractual rights of the holder of the claim or interest are not altered or modified.

(3) The holder of such claim or interest receives on account of such claim or interest cash equal to the amount of such claim or the greater of:

(a) any fixed liquidation preference to which the terms of any security representing such interest entitles the holder of the interest; and

(b) any fixed price at which the debtor under the term of such security may redeem such security from such holder. [§1124]

d. <u>Post-Petition Disclosure and Solicitation</u>.

(1) An acceptance or rejection of a plan may not be solicited after the commencement of a Chapter 9 or 11 proceeding from the holder of a claim or an interest unless at the time of or before such solicitation there is transmitted to such holder the plan or a summary of the plan and a written disclosure statement approved by the court after a notice and hearing and determined by the court to contain adequate information. [§1125]

(2) Adequate information is defined in the Bankruptcy Code as "information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interest of the relevant class to make an informed judgment about the plan." [§1125(a)]

(3) The debtor may tender different disclosure statements (differing in amount, detail or kind of information) to different classes of creditors. [§1125(c)]

e. <u>Acceptance of the Plan</u>. The plan must have the assent of two-thirds in allowed amount of each class and more than one-half in number of creditors of each class. [§§1126(c) and 1129(a)(8)(A)] Exceptions:

(1) <u>Non-impairment</u>. If the class is not impaired. [Section 1129(a)(8)(B)]

(2) <u>"Cram down"</u>. If the plan does not discriminate unfairly, and is fair and

equitable, with respect to each class of claims . . . that is impaired under, and has not accepted, the plan." [§1129(b)(1)]

If a Class is to receive nothing under a Plan, that Class is deemed to have rejected the Plan (§1126(g)).

f. Confirmation of Plan - Hearing and Requirements.

(1) After Notice to all interested parties the court shall hold a hearing on confirmation of a Plan. Confirmation is required if one of the impaired classes do not accept the Plan. A party in interest may object to the plan and a special taxpayer may object to the confirmation of the plan. [§§1128(a) and (b) and 943(a)]

(2) The court shall confirm a plan only if:

(a) It meets the specific requirements of Chapter 9 or 11 including being proposed in good faith and not by any means forbidden by law; and

(b) At least one class of claims has accepted the plan or the court has determined that "the plan does not discriminate unfairly and is fair and equitable with respect to each class of claims or interests that is impaired under, and has not accepted the plan." [§1129 (a)(2), (3), (8), (10) and (b)]

(c) There is a split of authority as to whether the requirements of §1129(a)(10) [requiring acceptance by at least one class of claims for confirmation] is satisfied by an unimpaired class which is deemed to have accepted the Plan [§1126(f)]. See pro In re W.E.

Parks Lumber Co., 19 B.R. 285 (Bankr. W.D.La. 1982); In re Landen Book Co., 13 B.R. 788 (Bank. W.D. Mo. 1981); Contra In re Pine Cove Village Appartment Co., 19 B.R. 819 (Bankr. S.D.N.Y. 1982); In re Barrington Oaks General Partnership, 15 B.R. 952 (Bankr. D. Utah 1982).

(3) In addition to the requirement for confirmation set forth above, the court shall confirm the plan if:

(a) The plan complies with the provisions of Chapter 9 or 11 [S1129(a)(1)];

(b) The plan complies with the provisions of other Chapters of the Bankruptcy Code made applicable to Chapter 9;

(c) All amounts to be paid by the municipality or corporate debtor or by any persons for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable [S1129(a)(4)];

(d) Debtor is not prohibited by law from taking any action necessary to be taken to carry out the plan [S1129(a)(3)];

(e) The plan of reorganization of the corporate debtor discloses any individual proposed to serve as officer, director or voting trustee of the debtor after confirmation of the plan or any insider that will be employed or retained by the reorganized debtor [S1129 (a)(5)];

(f) The plan provides that each holder of the claim of the kind specified in S507(a)(1) of the Bankruptcy Code will receive on account of such

claim property of value as of the effective date of the plan equal to the allowed amount of such claim, except to the extent that a holder of a particular claim of such kind has waived any such payment on such claim; and

(g) The plan is in the best interest of the creditors and is feasible. [SS943 and 1129]

g. Modification of Plan.

The proponent of a Plan in a Chapter 11 proceeding may modify the Plan:

(1) at any time prior to confirmation provided such modification otherwise meets the other requirements of Chapter 11;

(2) at any time after confirmation of the Plan but before substantial consummation provided such modification not only meets the other requirements of Chapter 11 but also the Court, after notice and hearing confirm such a Plan as modified and S1129. [S1127(a) and (b)]

A municipality in Chapter 9 may only modify a Plan before confirmation provided it otherwise meets the requirements of Chapter 9 and the modification takes effect upon filing. (S942) Any holder of a claim or interest in a Chapter 9 or 11 that has accepted or rejected a Plan is deemed to have accepted or rejected the plan as modified unless within the time fixed by the Court that holder changes the holder's previous acceptance or rejection. (S1127(d)).

h. Effects of Confirmation and Discharge.

(1) The provision of a confirmed plan binds the debtor and any creditor whether or not:

(a) a proof of claim is filed by such creditor;

(b) such claim is allowed;

(c) such creditor has accepted the Plan [§§1141(d) and 944(a)].

(2) The municipality is discharged of all debts as provided in the Plan are to be discharged upon confirmation and depositing of the consideration to be distributed with a disbursing agent and any security to be issued is determined by the Bankruptcy Court to be valid and binding on the debtor as provided in the Plan. [§944(b)].

i. Continuing jurisdiction and closing the case.

The Court may retain jurisdiction over the case for such period of time that is necessary for the successful execution of the Plan. Upon the completion of the Court's administration of the case the case will be closed. (§945).

B. *Selective Problems Arising Out of Municipal Bankruptcies.*

1. *Are Pledged Revenues Subject to Lien Termination or as Preferences or After-Acquired Property?*

a. Preference (§547).

It may be argued that a lien on revenues collected by municipality during 90 days prior to filing of petition is a voidable preference because §547(e)(3) provides that a transfer (including transfer of a security interest) is not made until the debtor has rights in the property. Under this view, to the extent that the pledge of such revenues would give creditor more than he would otherwise receive in liquidation, the attempt to create a security interest therein would constitute a voidable preference. However, the revenues may fall within exception relating to exchanges for new value. (See §9-306 of U.C.C.) The better view is that the revenues constitute "receivables" and hence only a partial preference results, to the extent of any net reduction in the excess of the secured claim over the value of the security. §547(a)(3)

defines a receivable as "a right to payment, whether or not such right has been earned by performance." (Note: the definition is broader than that of the Uniform Commercial Code for "accounts"). Also, if the lien on future revenues is voided as a preference, the result is at odds with public policy and state enabling legislation which almost invariably provides that pledges of such revenues are effective when made and good against other creditors.

b. Liens on After-Acquired Property (S552).

Under S552, a lien terminates upon bankruptcy as to property acquired after the filing of a petition except for "proceeds, product, . . ." etc. of property already subject to the lien. This section invalidates the reach of after-acquired property clauses to property acquired by the debtor after the filing of the petition. See First National Bank of Colorado Springs v. Hamilton, 18 B.R. 868 (D. Colo. 1982); In re Whitaker, 18 B.R. 314 (D. Kan. 1982). The only exception is for proceeds, a term that is largely undefined by the code or cases. (Most cases defining the term define its use in the U.C.C.) Unless the revenues collected after the filing of the petition can be traced as proceeds of some other property of the debtor which was subject to a lien prior to the filing, such revenues are not subject to a lien in favor of the bondholders. As set forth above, it can be argued that the right to receive revenues is "property". If the Trust Indenture or Bond Resolution specifies that it extends to "proceeds" of such property, it can be argued that the revenues are proceeds of that property. Perhaps one should distinguish those revenues which are collected after the filing but which are proceeds of tax assessments made before the filing from those which are assessed and collected after filing. The right to collect an assessed tax, where the

only matter remaining outstanding is the collection of the revenue, which would seem to be "property" and the subsequent revenue would be "proceeds" thereof. [By analogy to accounts receivable, where checks received by debtor in collection of accounts receivable are considered to be proceeds of the pre-existing accounts under the U.C.C. See In re S & Z Intern. Mgmt., Inc., 10 B.R. 580 (Fla. 1981)]

2. *Payments to Retire Bonds as Preferences.*

a. Payments to defease a bond issue may be deemed to be a preference under Section 547 depending upon the source and timing of the payment:

(1) If proceeds of a new bond issue (i.e. a "refunding issue") acquired during the preference period are specifically designated by the terms of the issue to be used to defease a prior indenture (predating the preference period) then probably no preference problems. Generally, new unsecured loans or payments to creditors by a third party are not transfers of debtor's property, if the property is never in debtor's estate but goes directly from third party to creditor. Estate of debtor is not diminished. If debtor gives new security for the refunding bond issue, then it may be argued that there is a diminution and there is a preferential transfer to the extent of collateral's value. See Virginia National Bank v. Woodson, 329 F.2d 836 (4th Cir. 1964); Steel Structures, Inc. v. Star Mfg. Co., 466 F.2d 207, 217 (6th Cir. 1972); Grubb v. General Contract Purchasing Corporation, 94 F.2d 70, 72 (2d Cir. 1939); National Bank of Newport v. National Herkimer County Bank, 225 U.S. 178 (1912). See also Miller v. Wells Fargo Bank International Corp., 406 F.Supp. 452, 463 (n.2) (D.C.N.Y. 1975), aff'd, 540 F.2d 584 (2d Cir. 1976). In re the Van Shop, Inc. v. Banc Ohio National

Bank, 8 B.R. 73, 75 (N.D. Ohio 1980). Note: payments to new bondholders not preferential because new value was given.)

(2) Similarly, use of funds deposited in a Debt Service Reserve Fund or with Indenture Trustee prior to preference period and paid out to bondholders during preference period probably not a voidable preference. "Transfer" occurred before preference period and debtor's estate not diminished. No additional security was given. Also, a payment into a Debt Reserve Service Fund during such preference period may be argued not to be a preference if funds were previously pledged and collected prior to preference period.

(3) By reason of S547(e)(3) the use of other previously accumulated revenues to retire bonds or defease an indenture during preference period probably constitutes a preference to the extent the funds were received during the preference period.

(4) Any other payment to defease indenture or retire bonds or to pay interest during the preference period probably constitutes a preference.

3. *Transformation of Revenue Bond Issue into General Obligation.*

a. If a pledge of future revenues is defeated by SS547(e)(3) and 552, or if a municipality seeks to use property of the estate which is secured by a lien on revenues which is without recourse to the municipality (Revenue Bond Issue) the otherwise revenue bonds may be transformed into in effect a recourse claim therefore changing a Revenue Bond Issue into a General Obligation. The Bondholders may elect as a class to have their entire claim treated as secured by the revenues or as with recourse. [Sections 506(a) and 111(b)] Such an election to be secured by revenues cannot be made if the collateral revenues pledged or held are used by the debtor for other purposes or

"sold" (pledged for other purposes) under the plan. Even if the bonds are revenue bonds they should probably be treated as having "recourse" against the debtor because of the state-law liability of the debtor from future revenues. Even if the bonds were treated as non-recourse, the separate unsecured portion where revenues used for other purposes or "sold" (used for other purposes) pursuant to the plan would be an allowable recourse claim, [S1111(b)(1)(A)]

b. Even if a creditor makes an election under 1111(b) to transform a claim into a recourse claim the question is posed whether the Revenue Issue is transformed, in effect, into a General Obligation of the municipal body which may be contrary to the state constitutional debt limitation.

4. *Special Problems Relating to "Conduit Financing".*

a. In certain conduit financing where the issuing municipality is a conduit for payments to the holders of the bonds by a private company there may be a preference problem due to Municipal Bankruptcy. To avoid such preference problems, it would be helpful to have not only the pledge of revenue by the municipal body who issued the bonds, but also the assignment to the Bondholders or Indenture Trustee of the contractual right to receive those payments from the private company.

b. The use of a Guaranty from the private company and the use of letter of credit may aid in solving the preference problems.

5. *Increasing Use of Letters of Credit as Backing for Municipal and Tax-Exempt Conduit Obligations.*

a. Letters of credit are not guarantees, and are not considered to be guarantees so as to be ultra vires for national banks. A letter of credit is considered to be the full faith and credit of a financial institution in the amount set forth therein. In drafting any letter of credit transaction it is important that all documents clearly indicate that the letter of credit is not a guarantee. A letter of credit upon presentment of specified

documents and fulfillment of certain conditions is an unqualified obligation to pay. See Wichita Eagle and Beacon Publishing Co. v. Pacific National Bank of San Francisco, 493 F.2d 1285 (9th Cir. 1974). See also In re Eastern Freight Ways, Inc. v. Seaboard Surety Co., 9 B.R. 653 (S.D.N.Y. 1981). In prior years, care had to be taken to make sure that the notices, actions and certificates necessary to make presentment on a letter of credit did not involve notices to be given to or received by the debtor or action against the debtor all of which could create problems given the automatic stay. Under the new amendments discussed below, the presentment of a negotiable instrument and the giving of notice, protest and dishonor of each instrument are not violations of the stay.

b. Survives bankruptcy. A letter of credit is an "independent" contract between the issuing bank and the beneficiary. Uniform Commercial Code §5-114, Official Comment, ¶ 2. As such, if the stated conditions are satisfied, it survives the bankruptcy of the debtor for whom it was issued. In re Page, 18 B.R. 713, 715 (D.C.D. 1982). In re Marine Distributors, Inc., 522 F.2d 791, 795-796 (9th Cir. 1975). Courtaulds North America Inc. v. North Carolina Nat. Bank, rev'd on other grounds 528 F.2d 802 (4th Cir. 1975). Neither the letter of credit nor its proceeds are property of the estate. In issuing the letter of credit, the bank agrees to pay out of its own assets. In re Page, id. (In the case of conduit financing the "debtor" for this purpose would be the corporation for whose benefit the municipality issued the bonds.)

c. The agreement between a bank and a debtor that provides for a secured claim to reimburse the bank by the debtor may be an "impermissible preferential treatment" of the unsecured beneficiary by means of the letter of credit. Matter of Twist Cap, Inc., 1 B.R. 284 (D. Fla. 1979). This opinion is probably wrong. (See e.g., In re M.J. Sales & Distributing Co., Inc., 9 BCD 1342 (S.D.N.Y. 1982) and has been limited to its facts by the Court which authored the opinion (Matter of St. Petersburg Hotel

Associates, Ltd., 37 B.R. 380 (Bankr. M.D. Fla. 1984)). However, if the same security is given to the beneficiary of the letter of credit as to the bank, Twist Cap problem should be solved.

d. Executory contract. With respect to payments to be made after commencement of the case, the agreement between the bank and the debtor (which is separate from the "independent" agreement between the bank and the bondholders) may be an executory contract to make a loan, which the trustee in bankruptcy cannot assume. S365(c)(2). Failure to assume would lead, however, to a damage claim. SS365(g) and 502(g).

6. *The Definition of Insolvency.*

Municipality is presumed to be insolvent during 90 days prior to the commencement of the case. [S547(f) of the Bankruptcy Code]. However, the test of insolvency is questionable if insolvency means that debt exceeds assets. [S101(26)(A) of the Bankruptcy Code]. Many municipalities may be termed "insolvent" if assets exempt from attachment by state law are excluded. However, S552 of the Bankruptcy Code (providing the exemption from State Attachment Law) is not incorporated into S901 and is not applicable to a Chapter 9 proceeding.

7. *The Required Maintenance of Municipal Service.*

The municipality while in a Chapter 9 proceeding will still have to function as a municipality. There are certain necessary and basic municipal services which must be provided such as police, fire and under certain instances, sewer, water and electrical services. A bankruptcy court and creditors will not be able to successfully interfere with such service. Accordingly, certain revenues and activities of the municipal body which may be the cause of the "insolvency" may not be able to be effectively restrained, curtailed, or modified without an impelling reason for such action.

8. *Treatment of Lease Obligations in Conduit Financing.*

In certain conduit tax-exempt financing the obligation to pay principal and interest on the Bonds is defined by lease obligation from the company

obtaining the benefit of the financing to the municipal body. This lease obligation is then normally assigned to the Indenture Trustee for the benefit of the Bondholders. Some corporate debtors have taken the position that the lease of the relevant facility which was financed by the conduit tax exempt Bonds has the claim on that lease reduced from the total amount of principal, interest and expenses due under the terms of the documents to a claim for the termination of a lease of real estate under the Bankruptcy Code. Under Section 502(b)(6) of the Bankruptcy Code a claim arising out of the termination of a lease of real estate is limited to the rent reserved by such lease, without acceleration, for the greater of one year or 15% not to exceed 3 years of the remaining term of such lease following the earlier of (i) the date the petition was filed instituting the action or (ii) the date on which such lessor repossessed or the lessee surrendered the leased property plus any unpaid rent due under such lease without acceleration as of the earlier of such dates. This position taken by certain corporate debtors is wrong because the lease in conduit tax exempt financing as was noted in the legislative history surrounding Chapter 9 of the Bankruptcy Code was a "financing lease" and not a lease of real estate. S. Rep. No. 95-989, 95th Cong., 2d Sess., 64, reprinted in [1978] U.S. Code Cong. and Ad. News 5787, 5850. Courts, when faced with this situation, have held that "financing leases" with regard to conduit tax exempt financing are not subject to the provisions of Section 502(b)(6). See In re Winston Mills, 6 B.R. 587 (S.D.N.Y. 1980). But see, Third National Bank v. Wisner Corp., 27 B.R. 383 (M.D. Tenn. 1982). It is, therefore, important from a Bondholder's position to have not only the lease obligation from the corporate debtor in a form where it is clear that it is a financing lease but also a guarantee of the corporate debtor of all obligations to pay principal and interest on the Bonds, thereby demonstrating the financing nature of the lease.

9. *Enforceability of Pre-Bankruptcy Subordination and Priority Agreement.*

Section 510(a) provides that "a subordination agreement is enforceable in a case under this title to the same extent it is enforceable under applicable nonbankruptcy law." In a leading case in this area, In re Credit Industrial Corporation, 366 F.2d 402 (2d Cir. 1966), the Court state that subordina-

tion agreements are almost uniformly enforced by bankruptcy courts, and further, that the enforcement of such agreements does not offend the policy of equal distribution of the Bankrupt's estate. See also In re Leasing Consultants, Inc., 2 B.R 165 (Bankr. E.D.N.Y. 1980); In re Holiday Mart, 715 F.2d 430 (9th Cir. 1983). Accordingly, subordination or priorities established by state law or prior contractual agreement should be enforceable in a Chapter 9 or 11 proceeding. For example, a municipal electrical utility may have entered into a power purchase contract and agreed pursuant to state law that such a contract payment is an Operation and Maintenance ("O&M") expense which is to be paid prior to its own Revenue Bonds (as is provided for by state statutue or the Bond Resolution for its Revenue Bonds). In a Chapter 9 proceeding the power seller can attempt to claim a right to payment from revenues superior to that of the Revenue Bondholder under a priority or subordination theory. Likewise, in a corporate conduit financing, the corporation's subordinated Debentureholders may, given the definition of subordination, be junior in right to payment to the Industrial Revenue Bondholders who have a corporate guarantee of the payment on the Bonds. The subordination and priority issue should be examined both pre- and post-bankruptcy in order to properly analyze the right to payment of Municipal Bondholders and other creditors.

10. *Treatment of Original Issue Discount Bonds in Bankruptcy.*

Paragraph (2) of Section 502(b) of the Bankruptcy Code requires disallowance of a claim in Bankruptcy to the extent the claim is for unmatured interest as of the date of the petition since the petition in bankruptcy accelerates principal and suspends the accrual of interest. Where an obligation is acquired at $950 due to an original issue discount and is valued at maturity at $1,000, it must be ascertained by the Bankruptcy Court how much of the $1,000 face amount represents principal and accrued interest as of the date of the filing of the petition. See Sexton v. Dreyfus, 219 U.S. 339 (1910).

11. *Security Fraud Claims and Indemnity.*

a. Security Fraud Claims.

A Court has held that the Tenth Amendment to the Federal Constitution does not protect a municipality's issuance of Industrial Development Bonds from application of the Federal Securities Law since issuance of such bonds does not rise to the level of traditional governmental function. Woods v. Home and Structures of Pittsburg Kansas, Inc. 489 F. Supp. 1270 (D. Kan. 1980). Any claims made in a Chapter 9 or Chapter 11 proceeding based on Federal or State Securities law ("for recission of a purchase or sale of a security of a debtor or of an affiliate or for damages arising from the purchase or sale of such security") are subordinate for the purpose of distribution to all claims and interests that are senior or equal to claims or interests represented by such security. Accordingly, security holders (or even bargain purchasers of securities) cannot elevate or increase their claim in a Chapter 9 or 11 proceeding alleging Federal or State Security Fraud law violations. [Section 510(c)] See H.R. Rep. No. 95-5959 95th Cong., 1st Sess (1977), p. 194.

b. Indemnity of Municipal Officers, Agents or Others.

Generally indemnification for liability of officers, agents and others under Federal and State securities law is not permitted. See e.g., Heizer Corporation v. Ross, 601 F.2d 330, 334 (7th Cir. 1979) ["Whereas contribution supports the policy of securities legislation, indemnification tends to frustrate and defeat it."]; Globus v. Law Research Service, Inc., 418 F.2d 1276, 1287-88 (2d Cir. 1969) [holding an indemnity agreement cannot be enforced against corporation for public policy reasons]. In re THC Financial Corp., 446 F. Supp. 1329 (D.Haw. 1977). Further, Bondholders and others can argue that any such indemnity claim if allowed should be subordinated under S510(c) of the Bankruptcy Code based on principles of equitable subordination. In equity no party is to profit from that party's own wrongdoing. The Bondholders

and other general trade creditors have extended credit in reliance upon the financial status of the debtor and the proper action of its officers, agents and those acting on its behalf, and therefore, the errant officers, agents and those acting on its behalf claim for Indemnity (judgment or legal fees and expenses) should be subordinate under S510(c). See Pepper v. Litton, 308 U.S. 295 (1939); In re Sterling Homex Corporation, 579 F.2d 206 (2d Cir. 1978); In re Mobil Steel Company, 563 F.2d 692 (5th Cir. 1977); In re American Reserve Corporation, Case No. 80 B 4786, United States Bankruptcy Court, Northern District of Illinois, Eastern Division, Unpublished Opinion dated September 10, 1980.

12. ***Treatment of Labor Contracts in Bankruptcy.***

On February 22, 1984, in the matter of National Labor Relations Board v. Bildisco and Bildisco, ___ U.S. ____, 104 S. Ct. 1188, 79 L.Ed.2d 482 (1984), the Supreme Court held that S365(a) of the Bankruptcy Code provides that, with certain exceptions, the trustee (or a municipality in a Chapter 9 proceeding) may assume or reject "any executory contract" of the debtor, including a collective-bargaining agreement.

a. Facts. Bildisco and Bildisco ("Bildisco"), a New Jersey general partnership in the business of distributing building supplies, filed a voluntary petition in bankruptcy for reorganization under Chapter 11 of the Bankruptcy Code, 11 U.S.C. S1101 et seq. Prior to filing, Bildisco had negotiated a three year collective bargaining agreement with the International Brotherhood of Teamsters, Chauffers, Warehousemen and Helpers of America ("Union") which provided that said agreement was binding on the parties and their successors regardless of bankruptcy. After filing, Bildisco requested permission from the Bankruptcy Court pursuant to Section 365(a) to reject the collective bargaining agreement. At the hearing, Bildisco's sole witness was a general partner who testified that rejection would save his company $100,000 in 1981.

b. Supreme Court Holding. A collective bargaining agreement is an executory contract

which is subject to rejection under Section 365(a). According to the Court, the fact that Congress did not exclude collective bargaining agreements from the scope of Section 365 indicates that Congress intended that Section 365 apply to said agreements. However, because of the "special nature" of labor agreements, the Court found that a standard for rejection more stringent than the normal "business judgment" rule should apply. See Group of International Investors v. Chicago Milwaukee St. Paul & Pacific R. Co., 318 U.S. 523; In re Minges, 602 F.2d 38 (2d Cir. 1979); In re Telco, Inc., 558 F.2d 1369 (10th Cir. 1977). According to the Court, the Bankruptcy Court should permit rejection of a collective bargaining agreement subject to §365(a) but only if the debtor can show that the agreement both burdens the estate and that the equities balance in favor of rejection. This would include a consideration of the likelihood and consequences of:

(1) liquidation for the debtor absent rejection;

(2) the reduced value of the creditors' claims that would follow from affirmance and the hardship that would impose on them; and

(3) the impact of rejection on the employees.

In striking the balance, the Bankruptcy Court must consider not only the degree of hardship faced by each party, but also any qualitative difference between the types of hardship each may face. Nevertheless, the Court rejected the test espoused by the Union that Bildisco should not be permitted to reject the collective bargaining agreement unless it could demonstrate that its reorganization would fail unless rejection was permitted.

c. Legislation. As set forth below, the recent Amendments modified Bildisco's holding regarding the standard to be applied and other aspects of the holding.

d. Impact on Municipal Bankruptcy. Given the fact that labor obligations are among the most burdensome problems faced by municipalities as evidenced by the San Jose School District bankruptcy, the Bildisco result obviously could be attractive to some local governments. However, municipal workers generally perform a governmental function. It is not clear then whether the Bildisco holding would govern a Municipal Bankruptcy, absent a resolution by the debtor municipality's legislative body, given the provisions of Section 904 of the Code which states that the Court cannot interfere with the political or governmental powers of the Debtor. Further, if Bildisco is to be applicable to a Chapter 9, a clearer standard for review by the Bankruptcy Court should be promulgated to ensure no violation of Section 904 and the Tenth Amendment.

13. ***Municipal Bankruptcy and Its Effect on the Ability of the Institutional Investor to Hold Municipal Bonds Pursuant to State Legal Investment Law.***

a. General Prohibition. A municipality may in a Chapter 9 proceeding obtain under §944 a discharge of its obligations including discharge of its obligations on its municipal bonds. Such a discharge may render the future securities issued by a municipality to be a prohibited investment under state legal investment laws governing investments by fiduciaries (see 90 C.J.S. Trusts §326) which arguably could prohibit institutions from investing in securities of a municipality that has defaulted on its obligation and subsequently received a discharge in bankruptcy. The trend is that most states are repealing such statutes and leaving investment decisions up to the Fiduciary.

b. Conflict of Federal and State Law. Some may argue that such state legal investment laws if applied to prohibit investment in the securities of a Chapter 9 Debtor are inconsistent with the "rehabilitative purposes of Chapter 9" since the effect of such law is to prevent a municipality using a Chapter 9 proceeding from being able after discharge of its debts to issue new securities which would be qualified investments under the

state investment law. Some may argue that the federal law should prevail over the state law given such a conflict. See Perez v. Campbell, 402 U.S. 637 (1971) and 11 U.S.C. S529 (protection of the Debtor from governmental discrimination). See also, 1978 U.S. Code Congressional and Administrative News, 5867. It should be remembered however that S525 does not apply to a Chapter 9 case, that S904 specifically prohibits bankruptcy court intrusion into the government and affairs of the municipality, and the Tenth Amendment prohibits the intrusion of federal statutes upon the rights granted to the state to govern its affairs and its political subdivisions. There was an attempt to provide in Chapter 9 that "any state law which directly or indirectly deprives the petitioner of the effect of confirmation under this Chapter is invalid" but this provision was deleted in conference. (See S.2597 to the original Chapter IX).

14. ***The Effect of Municipal Debt Adjustments and Workout on the Tax-Exempt Status of Municipal Bonds.***

a. Mandatory Issuance of Judgment Bonds to Pay Off Defaulted and Accelerated Bonds.

It can be argued that "tax exemption " on interest may be lost to the purchasers of Judgment Bonds which are issued pursuant to a mandamus action or order of the court due to a default and acceleration of a previous bond issue of the municipality. The basis for this argument is that the judgment bond, under these circumstances, is not an obligation of the municipality, voluntarily incurred. Accordingly, Internal Revenue Code (the "Code") S103 does not apply. State Statutes which authorize the issuance of Judgment Bonds under such circumstance might convince a Court that such new Judgment Bonds are voluntarily incurred pursuant to State law.

b. "Municipal Debt Adjustment" or Workout of Defaulted Bonds May Be a "Constructive New Issue".

Any "Municipal Debt Adjustment" or work-out of a defaulted municipal bond issue should be analyzed to determine whether or not the structure of the transaction is such that a "constructive issuance of a new obligation under Code S103" has taken place. Further, interest on "a constructive new issue" may not be tax-exempt due to changes in the law which occur after the issuance of the original obligations. [Such as: (1) public approval for the new issuance of Industrial Revenue Bonds would again have to be obtained, Code S103(k); (2) the limitations imposed by TEFRA on small issues Code S103(b)(6)(O); (3) the limitations imposed by TEFRA on the maturity of certain obligations (Code S103(b)(14)]. In order to determine whether or not a constructive issuance of a new obligation for purposes under Code S103 is caused by the proposed plan of "Municipal Debt Adjustment" or workout of a defaulted municipal bond, one must analyze whether or not there is a material change in the terms of the obligation.

c. <u>The Factors Which May Cause a Material Change in the Terms of the Bonds.</u>

(1) <u>Change of the Obligor.</u>

(a) <u>General Considerations.</u>

If an obligor defaults in its obligation and is replaced by another Debtor and at the time of the replacement there are material changes made in the terms of the bonds, the modified bonds may be treated as a "newly issued obligation" and if so the Bonds will have to satisfy again all Code S103 requirements if interest thereon is to be tax exempt. Rev. Rul. 81-281, 1981. On the other hand, if a new Debtor simply assumes all the former obligor's obligations on the debt and no material changes are made in the terms of the obligations, the change in the Debtors

should not affect the tax-exempt nature of the interest. Rev. Rul. 79-262, 1979. A mere change in an obligor unaccompanied by any material change in the terms of the underlying obligation should not result in the issuance of a new obligation for Code S103 purposes.

(b) Example.

(i) If a political subdivision issued bonds to construct a facility as part of industrial revenue bond financing and the bonds were secured by a mortgage note on the facility and the corporation defaulted on the mortgage note and the bond trustee foreclosed and sold the facility to a different corporation who executed a mortgage note with different terms than the prior note (alteration of either principal amount, interest rate or maturity) and the political subdivision did not approve the transfer or did not authorize making the new mortgage nor file an election to have the new bonds treated as an exempt small issue, interest on the bonds would probably no longer be tax-exempt.

(ii) Assignment by bankruptcy corporate obligor of its rights as lessee on municipal bond financed facility and assumption by a new private corporation of the bankrupt obligor's obligation under the lease and on the bonds should not affect the bonds' status under Code S103 even though credit enhancement (letter of credit or the guarantee insurance) which served as partial security for the bonds would be cancelled as a result of the transfer.

(c) Taxable Exchange.

It should be remembered in a Bankruptcy or workout that even though the tax exempt status on the interest may not be lost, the exchange may be taxable as an exchange under Code §1001(a) and (b). For example, the New York City ("NYC") notes on which the NYC had defaulted were exchanged for obligations of the Municipal Assistance Corporation ("MAC") and such was a taxable exchange since MAC's interest rates, collateral and maturity dates differed from those of the NYC Notes. LTR 7902002; LTR 7845001.

(2) Change in Interest Rate.

The change in interest rate on a defaulted issue in a workout or "Municipal Debt Adjustment" may under certain circumstances result in a constructive issuance of a new obligation in addition to the change in Debtor. If the Bondholder exchanges one set of bonds for another of the same obligor but at different interest rates then there is possibly a taxable exchange, unless all terms of the old and new bonds can be demonstrated to be identical. However, there is some evidence that in bankruptcy contexta change in interest rate even when there are other modifications in the terms of the original obligation may not result in the "constructive issuance of new obligations." See First Kentucky Company v. Gray, 309 F.2d 845 (6th Cir. 1962).

(3) Change in Maturity or Deferral on the Payment of Interest.

A change in the maturity date of an obligation or deferral of a payment

of interest or principal on obligations as indicated above may not necessarily result in the "constructive issuance of new obligations." In Schaefer v. U.S., 204 F.Supp. 473 (S.D. Ohio 1962) aff'd per curium, 312 F.2d 747 (6th Cir. 1963) cert. denied, 373 U.S. 933 (1963), the Court held that extending the interest payment on matured Japanese bonds, the payment of which had been subject to a moratorium during World War II, resulted in ordinary income not capital gain and the extension of interest on defaulted and matured bonds by new coupons did not produce an exchange on which gain or loss must be recognized. However, there are times when the extension of the maturity date can be a material change constituting a constructive new issue and this area is a mine field for any successful workout or Municipal Debt Adjustment.

C. *Selective Problems Arising Out of Corporate Reorganization (Conduit Financing).*

1. *Obtaining Credit (§364).*

As discussed supra, a Chapter 11 debtor is obligated under a "conduit municipal financing" to obtain secured or unsecured credit. This is in contrast to the debtor's inability to assume executory contracts to borrow money. Hence, the lender who wishes to proceed with a loan may enter into a new agreement, with adequate provisions to compensate for the additional risk inherent in lending to an insolvent borrower, but an unwilling lender will not be forced to perform under an executory loan agreement. If the debtor is unable to obtain unsecured credit (which is allowable as an administrative expense) the court, after notice and hearing, may authorize incurring of debt with priority over all administrative expenses, secured by a lien on property not otherwise encumbered, or secured by a junior lien on property that is already subject to a lien. If the debtor is unable to obtain credit any other way, the court may authorize incurring of debt secured by a senior or equal lien on property that is subject to a lien. The debtor has the burden of proving that the prior lienholder's inter-

est is adequately protected. The "adequate protection" standard of Section 364 replaces standards derived under prior case law dealing with the likelihood of a successful reorganization. Third Avenue Transit Corp., 198 F.2d 703 (2d Cir. 1952).

2. ***The Examiner/Trustee Problem (Section 1104).***

a. Appointment of Trustee. A trustee may be appointed by the court "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management," or if such appointment is "in the interest of creditors, any security holders and other interests of the estate." (The number of stockholders and amount of assets or liabilities of the debtor are not to be considered as cause. This language explicitly sets forth Congress' rejection of mandatory appointment of trustees for public companies.)

(1) The mismanagement of former management is to be distinguished from current management as is general mismanagement (which is probably present to some degree in any insolvent company) from gross mismanagement. The "best interests" standard is probably too vague to support appointment of a trustee on that basis alone, despite the legislative intent in drafting it, because it is difficult to imagine a situation where grounds will exist for appointment under the "best interest" standard where "cause" for such appointment will not also exist.

(2) Duties of Trustee. A Chapter 11 trustee has the following duties:

(a) to be accountable for all property received [S1106(a)(1) and 704(2)];

(b) if a purpose would be served, to examine proofs of claims and object to allowance of any claim that is improper [S1106(a)(1) and 704(4)];

(c) unless the court orders otherwise, to furnish such information concerning the estate and the estate's administration as is requested by a party in interest [S1106(a)(1) and 704(6)];

(d) to file with the court and appropriate taxing authorities, periodic reports and summaries of operations of the business [S1106(a)(1) and 704(7)];

(e) to make a final report and file an account of the administration of the estate with the court [S1106(a)(1) and 704(8)];

(f) file a list of creditors, schedule of assets and liabilities and a financial statement, if debtor has not already done so [S1106(a)(2) and 521(1)];

(g) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan [S1106(a)(3)];

(h) file a statement of any such investigation [S1106(a)(4)];

(i) file a plan, a report of why trustee shall not file a plan, or recommend conversion to Chapter 7 or 13 or dismissal [S1106(a)(5)];

(j) provide necessary information to taxing authorities for years in which debtor failed to file tax returns [S1106(a)(6)]; and

(k) after confirmation of the plan, file such reports as are

necessary or as the court orders [S1106(a)(7)].

(3) Pros and cons of Trustee: Appointment of trustee may be beneficial where creditor's confidence in debtor is low. But, there will be added expense of compensating trustee as well as delays and complications in having to deal with a third party who is not familiar with the debtor's business and transactions with creditors.

b. Appointment of Examiner. If the court does not appoint a trustee, at any time before confirmation of a plan, on request of a party in interest, and after notice and hearing, the court may appoint an examiner to conduct an investigation of the debtor. [S1104(a)] Such appointment is mandatory upon request if the debtor's fixed, liquidated unsecured debts, other than debts for goods, services or taxes, or owing to an insider, exceed $5,000,000. Otherwise, such appointment is required only if it is in the interest of creditors, any equity security holders, and other interests of the estate. [S1104(6)]

(1) The examiner is to conduct such an investigation "as is appropriate," including allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor. [S1104(b)]. This language as well as the legislative history suggest that the court has discretion in determining the scope of the investigation. (See House Report 95-595, Report of the Committee on the Judiciary re. H.R. 8200 at page 403).

(2) The examiner may perform some of the duties of a trustee. [S1106(b)]. Unless the court orders otherwise, the examiner shall investigate the acts, conduct, assets, liabilities and financial condition of the debtor, the operation of the debtor's business

and the desirability of the continuance of such business, and any other matter relevant to the case or to formulation of a plan [S1106(a)(3)] and file a statement of such investigation with the court. [S1106(a)(4)] Such investigation goes well beyond the historical functions of an examiner.

(3) Bondholder's interests are probably best served by an investigation having a broad scope, in which the examiner assumes as many of the duties of trustee as possible, with few restrictions on dissemination of the progress and findings of the investigation. Public debt holders are usually under-represented on creditors' committees and so must rely to a greater extent upon the investigative powers of the examiner to protect their interests.

3. *Conflicts of Interest.*

a. Dual Role of Lender and Corporate Indenture Trustee. The Trust Indenture Act of 1939 does not prohibit such a dual role and corporate issuers will often choose as indenture trustee the bank with whom they have ongoing credit relationships. Although the conflict may affect negotiation for investor protections in indentures as well as the trustee's performance after indenture securities have been issued, the conflict becomes most apparent and serious when the issuer becomes insolvent. (See Campbell and Zack, "Put a Bullet in the Poor Beast. His Leg is Broken and His Use is Past. Conflict of Interest in the Dual Role of Lender and Corporate Indenture Trustee: A Proposal to End It in the Public Interest," The Business Lawyer, Vol. 32, p. 1705, July 1979.) Under these circumstances, the trustee's ability to fully carry out his fiduciary duty to bondholders has been questioned. Legal remedies for breach of the duty may be inadequate because the bondholders seldom have the resources to investigate to determine if improprieties have occurred.

b. Dual Role of Creditors' Committee Member and Indenture Trustee. Although as an indenture trustee does not vote on a plan of reorganization, he may and in some cases should object to a plan of reorganization, demand disclosure of certain missing information or appropriate consideration of matters not contained in such a plan. This and other duties that may be imposed upon an indenture trustee by the terms of the indenture (e.g. to file and prove a claim and to use the care and skill of a prudent man in the exercise of his rights and powers on behalf of all bondholders) suggest that in certain circumstances, the indenture trustee should seek membership on the creditors committee. When doing so, he should consider making application to the court for a determination that no conflict of interest exists in his dual role as indenture trustee and committee member, since a member of a creditor's committee owes a fiduciary duty to all creditors, while the indenture trustee owes a fiduciary duty to all bondholders. See, May 13, 1982 Order of the court allowing indenture trustee to serve on Creditors' Committee in In re Wickes' Companies, Inc., Case No. LA-82-6659-WL pending in the United States Bankruptcy Court for the Central District of California. See also, Matter of REA Holding Corp., 8 B.R. 75 (S.D.N.Y. 1980); Woods v. City National Bond & Trust Company, 312 U.S. 262 (1941); York v. Guaranty Trust Company, 143 F.2d 503 (2d Cir. 1934); Rothchild v. Jefferson Hotel Company, 56 F.Supp. 315 (E.D.Mo. 1944).

IV. *RECENT AMENDMENTS.*

A. ***On July 10, 1984, President Reagan signed H.R. 5174, the Bankruptcy Amendments and Federal Judiciary Act of 1984 ("1984 Act"). This legislation consists of three main parts:***

1. Creation of a new Bankruptcy Court to replace the Bankruptcy Reform Act provisions found unconstitutional in Northern Pipeline in the Supreme Court's decision of June 28, 1982, (Title I of the 1984 Act);

2. Creation of additional district and circuit court judgeships (85), 40 to take effect in 1984, 45 to take effect in 1985; (Title II of the 1984 Act); and

3. Amendment of the Bankruptcy Code making changes in areas where either certain abuses or concerns were raised regarding the Bankruptcy Reform Act of 1978. (Such areas as rejection of labor contracts, grain storage facilities bankruptcies, repurchase agreements, time-sharing agreements, shopping center bankruptcies, and consumer credit.) (Title III of the 1984 Act)

B. *Jurisdiction, Court's Structure and Effective Date.*

1. *Judges and Courts*

H.R. 5174 creates a new Bankruptcy court pursuant to which Article I Bankruptcy judges are appointed for 14 year terms by the respective Circuit Court of Appeals and may hear cases and proceedings referred to them by the specific District Court. The District Court, pursuant to the 28 U.S.C. S1334(a) has original and exclusive jurisdiction of cases under Title 11. The 1984 Act, 28 U.S.C. S157(a) authorizes referral of such cases to Bankruptcy judges while 28 U.S.C. S557(b)(1) provides Bankruptcy judges may hear and determine all cases under Title 11 and all core proceedings as defined in the Act arising under Title 11 [See 28 U.S.C. S157(b)(2)(A-O) setting forth a non-exclusive listing of core proceedings.] Bankruptcy judges may hear non-core proceedings either with the consent of the parties or as a "magistrate" as in a preliminary hearing proposing findings of fact and conclusions of law to the District Court for a de novo review.

2. *Constitutionality of the Present Bankruptcy Court.*

Various members of Congress, the media and the legal profession, have expressed their opinion as to the constitutionality of the Bankruptcy Courts under the 1984 Act. It is probably safe to say that the Court's structure, the Article I status of judges and the jurisdictional parameters of Bankruptcy judges will continue to be tested and determined by the U.S. Supreme Court in the near future or changed by Congress. The 1984 Act raises one interesting constitutional issue, and that is the appointment of the Bankruptcy judges by Congress' continuation of present sitting Bankruptcy judges after the expiration of their terms on June 27,

1984. Congress had allowed the Bankruptcy judges' term of office to expire with the passage of the June 27, 1984 deadline and the lack of any legislation in that time period extending the judges' term in office.

Accordingly, Congress, in §121(e) of H.R. 5174 provides that the term of office of any Bankruptcy judge serving on June 27, 1984 is extended to and shall expire at the end of the date of enactment of H.R. 5174 (July 10, 1984). Section 106(a) of the 1984 Act provides that the terms of the office of Bankruptcy judges serving on the date of enactment (July 10, 1984) is extended to and expires four years after the date the judge was last appointed to office or on October 1, 1986, whichever is later. The issue raised is whether Congress has the power to appoint, in effect Bankruptcy judges. The Appointment clause of the U.S. Constitution (Article II, §2, cl. 2) provides the President, with the advice and consent of the Senate, shall appoint officers of the United States whose appointments are not otherwise provided for in the Constitution unless Congress vests the appointment of such officers in the President alone, in the Courts or in the heads of the departments. Congress in enacting the 1984 Act and by continuing the term of the Bankruptcy judges after their terms had expired casts doubt on the validity of that portion of the Act appointing the present Bankruptcy Judges. No doubt there will be a determination of Congress' power and authority to so act. Previous Court decisions may be in favor of striking Sec. 121(e) of the Act as unconstitutional. [See Buckley v. Valeo, 424 U.S. 1 (1976) (Court held that appointment of members of the Federal Election Commission violated the principles of separation of power as contained in the appointment cause, since members of Congress were to appoint certain numbers of the Commission). See also Springer v. Philippine Islands, 277 U.S. 189 (1928) (The Court held that the Philippine Islands could not provide for legislative appointment to executive agencies.)] However, the courts which have reviewed the issue to date have upheld this aspect of the 1984 Act. See Sec. IIIA2 infra.

3. *Abstention and Core Proceedings.*

The 1984 Act provides that the District Court must on a timely motion of a party abstain from hearing a proceeding based upon a state law claim or cause of action related to a case under Chapter 11, but

not arising under Title 11, or arising in a case under Title 11, if: (a) the action could not have been commenced in Federal Court absent the jurisdiction under §1334, and (b) such an action is commenced and can be timely adjudicated in a state forum of appropriate jurisdiction. This mandatory abstention provision does not exclude the District Court from abstaining on other grounds especially in cases involving state law where state law is unsettled. Any decision to abstain under §1334(c)(2) is not reviewable. Likewise, Congress in 28 U.S.C. §157(b)(2) has specifically enumerated the core proceedings in which the District Court need not abstain, such as: the administration of the estate; allowance and disallowance of claims (except liquidation or estimation of contingent or unliquidated personal injury awards or wrongful death claims against the estate); orders respecting obtaining of credit, turnover of property; proceedings to determine avoid or recover preferences; motions to terminate, annul or modify automatic stays; proceedings to determine, avoid or recover fraudulent conveyances; determinations as to dischargeability of particular debts; objections to discharges; determination of validity and extent or priority of liens; confirmation of plans; orders approving the use or lease of property including use of cash collateral orders; orders approving sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate, orders effecting liquidation of assets, except personal injury tort or wrongful death claims). It is estimated that such core proceedings constitute 95% of all Bankruptcy matters. (See 130, Cong. Rec. H 1846-1848 (daily ed. March 21, 1984).

4. *Appellate Review.*

Under the 1984 Act, 28 U.S.C. §158, provision is made for review by Courts of Appeals, District Courts and the Bankruptcy Appellate Panels. Under §158(a) the District Court can hear appeals from final judgments, orders and decrees entered by Bankruptcy judges in cases referred to them by District Court, and also, with leave of court, interlocutory orders and decrees. Under 28 U.S.C. §158(b) Bankruptcy Appellate Panels ("BAP") continue as they did under the Bankruptcy Reform Act of 1978 with some new restrictions placed upon review. The new Act requires consent of the parties to the use of BAPs and also a majority of the District Judges for the district must vote to

authorize BAPs within the District. Further, under 28 U.S.C. §158(c), a party may take an appeal to the District Court or BAPs in the same manner as provided for appeals to the Court of Appeal in the time provided by Bankruptcy Rule 8002. Also Court of Appeals have jurisdiction over appeals from District Court and BAP under 28 U.S.C. §158(d).

5. *Effective Date.*

a. Title I dealing with the Bankruptcy Court's jurisdiction and procedure is effective generally as of the enactment of H.R. 5174 (July 10, 1984); however, the the appointments and salary of Bankruptcy judges is effective as of June 27, 1984.

b. Title III dealing with the amendments to the Bankruptcy Code, 11 U.S.C. §101 et seq. is effective ninety (90) days after the date of enactment of H. R. 5174 (October 10, 1984) with a few exceptions. (Section 1113 governing rejection of collective bargaining agreements is effective upon the date of enactment, July 10, 1984, but is not to apply to cases commenced prior to enactment.)

C. *Rejection of Collective Bargaining Agreement.*

1. *Rejection of the Bildisco Standard.*

As noted above, Congress in the 1984 Act has responded to this Supreme Court's decision of N.L.R.B. v. Bildisco & Bildisco, ___ U.S. ___, 104 S.Ct. 1188, 79 L.Ed. 2d 482 (1984), permitting unilateral rejections of a collective bargaining agreement by a debtor. The Supreme Court in Bildisco has rejected the standard whereby collective bargaining agreements can be rejected only if it can be demonstrated that such was onerous and burdensome and would thwart the efforts to save the debtor from collapse. [See Brotherhood of Railway and Airline Clerks v. REA, 523 F.2d 164 (2d Cir. 1975)]. Congress has added Section 1113 to the Bankruptcy Code which as noted above has the effect modifying the Supreme Court's ruling with regard to rejection of collective bargaining agreements and prohibiting unilateral rejection without a Court hearing and ruling upon an application for such rejection.

2. *Standard for Rejection.*

Under 11 U.S.C. §1113(c) a Court shall approve an application for rejection of a collective bargaining agreement only if a Court finds that:

"1) the Trustee [or Debtor] has prior to the hearing made a proposal that fulfills the requirements of subsection (b)(1);

2) the authorized representative of the employees has refused to accept such proposal without good cause ["good cause" is an undefined term]; and

3) the balance of the equities clearly favors rejection of such agreement." The thrust of the present legislation is to allow a Court supervised balancing of interests between the collective bargaining agreement and the rehabilitation of the company. The legislation appears directed at ad hoc determinations by a Court without detailed and defined guidelines. The success of §1113 will depend upon the discretion and future decisions of the Courts.

3. *Provision of Emergency Interim Relief.*

Congress recognized, in §1113(e) the need for Emergency interim relief and authorized interim changes pending full hearing and determination by the Court for permanent changes. Such interim changes would be granted only if essential to the continuation of debtor's business or in order to avoid irreparable damage to the estate. The Court may order interim changes after notice and a hearing scheduled in accordance with the needs of the trustee or debtor.

4. *Debtor's Required Disclosure of Financial Information and Offer.*

Congress in §1113(b)(1) requires the debtor to make a proposal to the authorized representative of the employees based upon the most complete and reliable information available at the time setting forth the modifications in employee benefits and protections necessary to permit the reorganization of the debtor in a manner which is fair and equitable to all creditors and affected parties. This section also requires that all representatives of the employees be provided with relevant

information as is necessary to evaluate the proposal. It appears that S1113(e) combined with the full disclosure requirements contained in S1113(b)(1) may have the practical result of having Courts order interim changes while authorizing and allowing representatives of employees to review the relevant information and enter into further negotiations.

5. *Expeditious Hearing.*

Section 1113(d)(1) provides for expeditious Court review providing that upon the filing of an application for rejection, the Court shall schedule a hearing to be held not later than 14 days after the date of filing such application, however, the Court may extend the time for commencement of such hearing for a period not exceeding 7 days where the circumstances of the case and the interests of justice require such extension or for additional periods to which the trustee or debtor and the representative of the employer may agree. If the Court does not rule on such application within thirty days after the date of the commencement of the hearing or within such additional time as the trustee (debtor) and employees' representative may agree, the trustee (debtor) may terminate or alter any provision of the collective bargaining agreement pending the ruling of the Court. (28 U.S.C. S1113(d)(2)). This tight time-frame may in effect require agreement between the debtor and the representatives of the employees for interim relief under Section 1113(e) while additional discovery and analysis is conducted by the authorized representatives of the employees. The facts of the situtation may require the Court to authorize the debtor to proceed with interim changes in the collective bargaining agreement while the authorized representative of the employees conduct the discovery necessary to adequately represent the employees' interest. Absent full discovery and analysis as inappropriate result can be obtained by either the debtor or the authorized representative of the employees.

6. *Applicability to Chapter 9.*

There is no reference or amendment contained in the 1984 Act or Section 901 of the Bankruptcy Code that would indicate that Section 1113 would be applicable to the Chapter 9 proceeding. Further, Bildisco may be applicable and still valid as to a Chapter 9 to the extent it is not inconsistent

with Section 904 of the Bankruptcy Code and the Tenth Amendment.

D. ***Repurchase Agreement.***

Repurchase Agreements ("Repos") are in essence the agreement pursuant to which borrowers sell securities to lenders and simultaneously agree to repurchase the securities at a set price at a later date. These repurchase transactions provide a mechanism of limited term investment involving certain securities (usually U.S. Government and agencies, mortgage-related instruments, commodities and money market instruments such as certificates of deposit, banker's acceptances and commercial paper). This Repo market constitutes a significant part of the security transaction in the United States. Thirty-six members of the Association of Primary Dealers in the U.S. Government's Securities alone engage in Repo transactions amounting to $25 to 30 billion dollars each day and the aggregate daily amount of Repo transactions amounting to several hundred billion dollars (see S. Rep. 98-65, 98th Cong., 1st Sess., 45). The effective operation of this market can only be assured if the investors are protected against the insolvency of the dealer or related parties in the Repo transactions. Given this inter-related nature of the parties to the transaction collapse of one institution in the Repo market could have significant repercussions throughout the securities industry. The 1984 Act in Title III, F is intended to provide protection to the Repo market.

1. ***Definition.***

Section 101 of the Bankruptcy Code has added new subsections 35 and 36 defining respectively "Repo Participants" and "Repurchase Agreements." Repurchase agreements means "an agreement, including related terms, which provides for the transfer of certificates of deposits, eligible banker's acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by the United States or any agency of the United States against transfer of funds by the transferee of such certificates of deposit, eligible banker's acceptances, or securities with simultaneous agreement by such transferee to transfer to the transferers thereof certificates of deposit, eligible banker's acceptances, or securities as described above at a date certain not later than one year after the transfers or on demand against the transfer of funds." Repo participant means, "an entity that, on any day during the period beginning 90 days before the

date of the filing of the petition, has an outstanding repurchase agreement with the debtor."

2. *Modification of Automatic Stays.*

Section 362 (b) is modified by the insertion of a new paragraph 7 which provides that the filing of a Bankruptcy petition does not operate as a stay as to the settlement by a Repo participant of any mutual debt and claim under or in connection with the repurchase agreement that constitutes the set-off of a claim against the debtor for a margin payment, or a settlement payment, as defined in S741(5) or (15) or (8) of the Bankruptcy Code arising out of the repurchase agreement against cash, securities or other property held by or due from the Repo participant to margin, guaranty, secure or settle repurchase agreements.

3. *Limitation on Trustee Avoidance Power and Elimination of Preferences.*

The 1984 Act, by amending S546 of the Bankruptcy Code and inserting a new paragraph, provides that a Trustee may not avoid a transfer that is a margin payment or a settlement payment made by or to a Repo participant in connection with a repurchase agreement that is made before the commencement of the case except as provided for in S548(a)(1) of the Title which deals with fraudulent transfers and obligations. Further, S548(d)(2) of the Bankruptcy Code is amended to provide that a Repo participant that receives a margin payment in connection with a repurchase agreement takes for value to the extent of such payment. Accordingly, any legitimate payment on a repurchase agreement which constituted a margin payment or settlement payment would not be a voidable preference under S547.

4. *Contract Right to Liquidate a Repurchase Agreement.*

The new S559 is added to the Bankruptcy Code under the 1984 Act which provides that the contractual right of a Repo participant to cause liquidation of a repurchase agreement shall not be stayed, avoided or otherwise limited by the operation of any provision of the Bankruptcy Code or by an Order of Court or administrative agency in any proceeding unless the debtor is a stock broker, securities clearing agency and such order is authorized by the Securities Investors Protection Act

of 1970. Further, in the event the Repo participant liquidates one or more of the repurchase agreement with the debtor, under the terms of one or more of such agreements, and the Repo participant has agreed to deliver assets subject to the repurchase agreement to the debtor, any excess of the market price received on liquidation of such asset over the sum of the stated repurchase price and all expenses in connection with liquidation of the repurchase agreement shall be deemed property of the estate subject to the rights of set off. This has the effect of allowing the liquidation of the repurchase agreement pursuant to its terms with any "profits" less expense of liquidation going to the debtor.

E. *Changes to Section 547 (Preferences).*

Changes to S547(b)(4) allow the trustee to avoid preferential transfers between 90 days and one year before the date of filing a petition. If the creditor at the time of the transaction was an insider, no longer is the debtor or trustee required to demonstrate that the insider had reasonable cause to believe that the debtor was insolvent at the time of the transfer in order to avoid the transaction. This provision will lead to in effect a "presumption" of insider transaction being preferential during the period of one year prior to Bankruptcy regardless of knowledge and the expectation of all creditors. Further S547(c)(2) is amended to prevent the trustee from avoiding payments made in the ordinary course of business of debts incurred in the ordinary course of business according to ordinary business terms even though the transfer is made later than 45 after the debt was incurred. This elimination of forty-five day rule may provide some comfort to buyers of commercial paper with maturities in excess of 45 days. Also, a new S547(g) was added to the Bankruptcy Code to set forth a burden of proof allocation. Under this section, the burden of proving the avoidability of a transfer is on the trustee and the creditor or parties in interest against whom recovery or avoidance is sought has the burden of proving nonavoidability of the transfer.

F. *Governmental Unit's Objection to Chapter 11 Plans.*

Section 1129(d) of the Bankruptcy Code provides that governmental bodies may object to a Chapter 11 plan of a corporation if the principle purpose of the plan is the avoidance of taxes or the avoidance of S5 of the Securities Act of 1933. The 1984 Act amends 1129(d) to require that the governmental unit has the burden of proving that the principle purpose of the Chapter 11 plan is such avoidance so as to require denial.

G. *Specific Amendments to Chapter 9.*

There are a number of specific amendments to Chapter 9, some are technical non-substantive changes, but some are of interest including the following:

1. Section 902 of the Bankruptcy Code is amended to read as follows: "'special tax payer' means record owner or holder of legal or equitable title to real property against which a special assessment or special tax has been levied, the proceeds of which are the sole source of payment of an obligation issued by the debtor to defray the costs of an improvement relating to such real property." (change underlined)

2. Section 922(a)(l) is modified to read as follows: "the commencement or continuation, including the issuance or employment of process, of a judicial administrative or other action or proceeding against an officer or an inhabitant of the debtor that seeks to enforce a claim against the debtor." (change underlined)

3. Section 927(b) is amended to read as follows: "The Court shall dismiss a case under this chapter if confirmation of a plan under this chapter is refused." (change underlined)

4. Section 943(b) of the Bankruptcy Code is amended to read as follows: "(4) The debtor is not prohibited by law from taking any action necessary [deletion] to carry out the plan; (5) except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides on the effective date of the plan each holder of a claim of a kind specified in §507(a)(l) of this title, will receive on account of such claim cash equal to the allowed amount of such claim." (change underlined)

5. Section 945(a) is amended to read as follows: "The Court may retain jurisdiction over the case for such a period of time as is necessary for the successful implementation of the plan." (change underlined)

H. *Leasehold Management Amendments and Others.*

The 1984 Act has a number of other changes, which should not significantly effect a Chapter 9 proceeding, and which are not discussed herein, such as changes relating

to consumer credit, grain storage facility Bankruptcy, shopping center Bankruptcy, discharge of debts incurred by drunk drivers and time sharing agreements and a number of small corrective changes. With regard to shopping center bankruptcies, and the real estate lease amendments, it should be noted as set forth above that any conduit municipal financing for industrial revenue bond purposes which involve a lease should not be treated as a real estate lease, but rather as a financing lease for Bankruptcy purposes. Amendments to S365 contained in the 1984 Act provide that a non-residential lease is deemed rejected if the debtor or trustee does not assume or reject the lease within the 60 days of the date of filing or order of relief or such longer time as the Court may fix. If rejected the trustee or debtor must surrender the premises to the landlord (11 U.S.C. S365(d)(4)). Accordingly, those provisions are not discussed in detail and should be, of little or no applicability in Chapter 9 proceeding. If such were applicable to municipal conduit financing and municipal leases then S502(b)(7) (limiting a landlord claim) could be applicable contrary to legislative intention and the intention of the parties to the transaction.

V. *NEED FOR LEGISLATIVE CHANGE.*

A. *Present Requirement for Change.*

1. *Chapter 9 May be Needed by Municipalities.*

The proposed amendments are limited but necessary. As we all know, Municipal Bond financing is part of the foundation upon which our present municipalities have been built and will be necessary for the future survival of our municipalities. There will be a number of cities, especially small and medium cities, which will face serious budgetary problems during the later half of the 1980's. These are the cities which most likely will need continued municipal finance, especially for necessary improvements or maintenance to infrastructure.

2. *Chapter 9 Interferes With Continued Ability to Finance.*

If financially troubled cities seek any relief under Chapter 9 of the Bankruptcy Code, there will be increasing concern relating to termination of the pledge of revenues from such municipal improvements under S552(a) of the Bankruptcy Code. Further, a financially troubled municipality will be

questioned about the extension of any credit during the 90 day period prior to a Chapter 9 proceeding since any pledge or payment on the Bonds could be deemed a "voidable preference" under S547 of the Bankruptcy Code. Likewise, Bondholders of Revenue Bonds who find the municipality using the pledge revenues in bankruptcy to pay necessary municipal expenditures may elect to transform that revenue bond into a "recourse debt" under S1111(b), contrary to statutory or constitutional debt limitations.

3. ***Amendments Are Necessary if Chapter 9 is to be of any Benefit to Municipalities.***

Amendments to the Bankruptcy Code which are set forth below seek to provide assurances to Investors that in providing the necessary financing for municipalities which are experiencing a temporary cash flow crisis, the pledge of revenues for payments made on such obligations will not be terminated or any payment received by the Bondholders forced to be repaid. It should be noted there would be significant difficulty in requiring municipal bondholders who may number in the thousands to tens of thousands to repay an interest payment which was made during the 90 day period since most of those bondholders live outside the regional area, the cost and expense of retrieving such "preference payments" is prohibitive, and the ability to retrieve all such payments virtually impossible since the bonds are publicly traded and the holders, pre and post Chapter 9, may change.

B. ***The Difficulties Encountered by a Municipality in a Chapter 9 Proceeding Due to Section 547, 552(a) and 1111(b).***

1. ***Operation of Section 547 in a Chapter 9 Proceeding.***

a. As referred to abaove, given the present state of the Bankruptcy Code, it may be argued that a pledge of revenues or a collection of such revenues by a municipality or the payment of such revenues to the bondholders during ninety days prior to the filing of a Petition is a "voidable preference" because S547(e)(3) provides that a transfer (including the transfer of a security interest) is not made until the Debtor has rights in the property.

b. Further, payments to defease a bond issue, by an advanced refunding or new bond issue, may be deemed to be a preference under S547 depending upon the source and timing of the payments. Troubled municipalities which desperately need additional financing may experience the reluctance of the Market to purchase securities because under the Bankruptcy Code a "refunding issue" might be termed a preference or the payments of pledged revenues within the 90 day period would be deemed under S547 to be a preference. The above-cited application of S547 in a Chapter 9 proceeding appears to violate the provisions of S904 of the Bankruptcy Code since the Bankruptcy Court and the Bankruptcy Code are not intended to affect the municipality's use of its revenues and for that matter the use of its revenues as payment to bondholders pursuant to their claims and rights under State law.

c. As briefly referred to above, there are a number of arguments which municipalities and their bondholders may offer to a court to alter the undesired effect of S547 yet it is questionable whether a Court, without modification of the language of S547 as applicable to a Chapter 9, will accept these arguments. Municipalities may argue that:

(1) Pledged revenues may fall within the exception relating to exchanges for new values as provided for in S9-306 of the Uniform Commercial Code and accordingly the security interest which is pledged to the bondholders in a new revenue bond issue which is consummated within ninety days of the date of the municipality's instituting a Chapter 9 proceeding should not be held voidable.

(2) Pledged revenues constitute receivables and hence only a partial preference results to the extent of any net reduction in the excess of the secured claim over the value of the securities. Section 547(a) defines a receivable as a "right to payment whether or not such right has been earned by performance". (Note the

definition is broader than the Uniform Commercial Code definition for "accounts").

(3) The U.S. Constitution (Tenth Amendment and Impairment of Contracts Clause) and State Statutes (granting unconditional pledges of revenues to bondholders) mandate a different result. If the lien on future revenues is voidable as a "preference" this would be contrary to public policy and State enabling legislation which almost invariably provides that the pledges of such revenues are effective when made and good against other creditors.

There is no assurance that these arguments will be universally persuasive with all Courts; thus legislative change to prevent the ill effects of §547 is warranted.

2. *The Operation of Section 552(a) in a Chapter 9 Proceeding.*

a. In connection with current municipal defaults and threats of municipal bankruptcy, there has been concern on the part of the Municipal Bond Market as to whether a municipality's pledge of revenues to bondholders terminates upon the filing of bankruptcy similar to the termination of the lien of creditors of a corporation on its accounts receivable, inventory and income. This issue has not been directly decided by the Courts. Some Bankruptcy Courts in non-Chapter 9 proceedings have held that they are without power to terminate statutory tax liens. Further, there are numerous legal arguments that can be made to a Court such as:

(1) The right to receive revenues so pledged to the bondholders is a State granted property right and such a constitutional and statutory property right cannot be interfered with by a Bankruptcy Court;

(2) A trust indenture or bond resolution that specifies that it extends to the "proceeds of such property" covers

the revenues as proceeds of that property when such are collected by the taxing entity even after the institution of a Chapter 9;

b. It would be contrary to the Tenth Amendment and the very principles upon which the Municipal Bankruptcy Act of 1937 was predicated and declared constitutional, for a Bankruptcy Court to state, pursuant to §552(a) of the Bankruptcy Code, that a pledge of revenues made by a municipal body pursuant to a state statute or a properly enacted bond resolution can be terminated upon the institution of a Chapter 9 proceeding. In further support of this practical approach to whether or not the pledge of revenue to bondholders is terminated by the institution of a municipal bankruptcy, one need only look to §904 of the Bankruptcy Code which specifically provides that "Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order or decree in the case or otherwise interfere with...any of the property or revenues of the debtor...".

c. It can be argued that the Tenth Amendment and §904 prohibit the interpretation that pledges of revenues granted pursuant to state statute or constitutional provisions to bondholders can be terminated by the filing of a Chapter 9 proceeding. State law prescribing a method of composition of indebtedness may not bind any creditor that does not consent as recognized by §903(1) of the Bankruptcy Code. Likewise, under the Contract Clause of the Constitution, Article I, Section 10, a municipality cannot claim that a contractual pledge of revenue can be terminated by the filing of a Chapter 9 proceeding. See United States Trust Co. v. New Jersey, 431 U.S. (1977); Davies v. City of Minneapolis, 316 N.W.2d 498 (D.Minn. 1982).

3. *The Operation of Section 1111(b) in a Chapter 9 Proceeding*

a. A municipality in a Chapter 9 proceeding will need sufficient cash flow to pay ongoing necessary municipal expenditures such

as Police, Fire, Sanitation, Water and Electricity. The municipality may attempt to use revenue generated by a profitable municipal operation even though such is pledged to revenue bondholders. Under S362, the revenue bondholders are stayed from commencing an action against the municipality for diversion of revenues. The Bondholders could bring an action under S362(d) for adequate protection or lifting the stay. The Bondholders could under S1111(b) transform their "non recourse" Revenue Bond Issue into a "recourse" (general obligation) of the municipality.

b. Even though the legislative history and S904 of Chapter 9 recognizes that the Bankruptcy Court should not interfere with the revenues, government and affairs of the municipality and the application of S1111(b) may cause the municipality to exceed its constitutional or statutory debt limitation. There is no social redeeming purpose for S1111(b) to be applicable to a Chapter 9 proceeding.

VI. PROPOSED CHANGES TO THE BANKRUPTCY CODE RELATING TO MUNICIPAL BANKRUPTCY.

A. Elimination of Applicability of Section 552 to a Chapter 9 Proceeding.

Section 552 of the Bankruptcy Code is made applicable to a Chapter 9 proceeding by reference in S901(a) of the Bankruptcy Code to S552. Various questions have been raised that a pledge of municipal revenue and the lien created thereby will be terminated in a municipal Bankruptcy due to the application of S552(a) to Chapter 9. To eliminate the confusion and to confirm various state laws and constitutional provisions regarding the rights of Bondholders to receive the tax revenues pledged to them in payment of debt obligations of the municipality, S901(a) of the Bankruptcy Code should be amended to strike S552's applicability to a Chapter 9 proceeding.

B. Clarification of the Applicability of Section 547 (Preferences).

In order to clarify that payment of pledged revenues is not a preferential transfer under S547 of the Bankruptcy Code, if such is made within 90 days of the filing of the petition, there should be an amendment to S547 to specifically exempt such payments of pledged municipal

revenues and defeasance of certain municipal bond issues from pledged or dedicated funds. This can be accomplished by specific amendment of S547 or S901(a) of the Bankruptcy Code should be amended to delete any reference to S547(e)(3).

C. *Transformation of Revenue Bond Issue Into General Obligation.*

In order to avoid use by a municipality in the Chapter 9 proceeding of revenues pledged pursuant to a revenue bond issue and thereby allowing the relevant Bondholders to transform that issue into a general obligation under the terms of S1111(b) of the Bankruptcy Code, there should be specific modification of 1111(b) to state that it is not applicable to a Chapter 9 proceeding and deleting S1111(b) from S901(a) of the Bankruptcy Code. At least there should be a specific statement in Chapter 9 that given constitutional debt limitations any such possible transformation under S1111(b) is limited by the constitutional and statutory debt limitations placed upon municipalities by the various states.

D. *Clarification of Municipal Insolvency.*

In order to clarify the ambiguity and possible detrimental effect to Bondholders regarding the standard to be applied in order to determine the "insolvency" of a municipality for purpose of preferences and other Bankruptcy considerations, it is important to clarify S101(26) of the Bankruptcy Code by deleting its applicability to municipalities or setting forth a new standard such as: "with reference to a municipality, insolvency shall mean that it is unable to meet its debts as such mature". Without such amendment the definition of "insolvency" could be misinterpreted to mean where debts exceed assets and, under S101(26), most municipalities would be "insolvent" since assets exempt from attachment by state law would be excluded which in most states is the bulk of municipal assets. However, Section 552 of the Bankruptcy Code (protecting the exemption from State Attachment law) is not incorporated into Section 901 and is not applicable to a Chapter 9 proceeding. Also in this regard, S109(c) of the Bankruptcy Code should be amended. [S109(c)(3) states: "is insolvent or unable to meet the entity's debt as such debts mature"; the disjunctive phrase should be eliminated.]

E. ***Regulatory Approval.***

With regard to any regulatory approval such as a municipal utility approval from either another regulatory body or from an electorate in order to effectuate a plan of adjustment, confirmation of any plan of adjustment should be after regulatory approval or specially conditional thereon. For example, regulatory approval by a state or federal government utility regulatory body is not required as part of a plan of adjustment by a municipality, even though for a corporate utility such regulatory commission approval is a necessary part of a plan. Accordingly, §901(a) should incorporate §1129(a)(6) as part of a plan of adjustment and also should contain additional language added to §943 that in any plan premised on either electoral or regulatory approval, such must be obtained prior to confirmation of such plan or such plan will be specifically conditioned on such approval being obtained in a specified period of time.

F. ***The Continuation of Payment of Revenue Pledged to Bondholders During the Chapter 9 Proceeding.***

Section 922 of the Bankruptcy Code should be modified to specifically provide that the automatic stay does not stay or interfere with previous pledge of revenues by the municipal body to Bondholders and that the levy, collection of such taxes and payments to Bondholders should be made in the ordinary course absent a Court order authorizing the municipality to delay or withhold such payment or authorize the use of such revenues for other purposes and provided there is a demonstration by the municipality that the Bondholders are adequately protected in accordance with §361 of the Bankruptcy Code and provided a super priority lien in accordance with §507(b) of the Bankruptcy Code.

G. ***Recognition of "Financing Lease".***

In order to avoid in tax exempt conduit financing a corporate debtor contending that a lease in a real estate lease limited to a claim under §502(b)(7) to far less than the total amount of principal, interest and expenses due on the Bonds, §502(b)(7) should be amended to provide that leases in tax exempt conduit financing shall be treated as "financing leases" and the claim on said lease shall be equal to the principal, interest and expenses due on the Bonds.

NOTE: This is an outline prepared for discussion purposes and is not intended and should not be construed as a statement of substantive law.

Appendix A

Monday, May 14, 1984

Is There Life After Default?

By James E. Spiotto
Special to The National Law Journal

THERE IS A saying, "In medicine mistakes are buried; in municipal finance they're refunded." There comes a time, however, when certain mistakes cannot be refunded. Given present conditions, the probability has increased that a municipality will be faced with a bond default and will consider instituting a proceeding for municipal debt adjustment under Chapter 9 of the Bankruptcy Code, or bondholders may be forced to seek their remedies. It is important that certain myths that exist concerning municipal bond defaults, remedies and municipal bankruptcy are dispelled; and that counsel who may be advising the municipality or bondholders are aware of the true reality from an historical and legal basis.[1]

WPPSS, San Jose School District

The past year has presented two striking examples of the financial difficulties that may confront municipalities. The default by the Washington Public Power Supply System (WPPSS) on its Project 4 and 5 Bonds not only was one of the largest municipal defaults in United States history (constituting approximately 0.7 percent of the principal amount of municipal bonds outstanding) but also raised a plethora of unsettling questions regarding bondholder rights and remedies. It appears that neither WPPSS nor the bondholders can agree whether bankruptcy should occur. However, neither bankruptcy of WPPSS nor annihilation through litigation need take place, with the inevitable legal meltdown of both WPPSS and the bondholders. There are alternatives.

In contrast is the case of the San Jose, Calif., School District. The district did seek the protection of Chapter 9 in order to resolve what were considered to be burdensome labor contracts. This Chapter 9 proceeding represents by far the largest municipal body to file a Chapter 9 petition since Oct. 1, 1979, the effective date of the new Bankruptcy Code. However, despite resorting to Chapter 9, the district made it clear that the bondholders would be paid. The parties whose rights are intended to be impaired in the district's Chapter 9 proceeding may attempt to contest and interfere with the timely payment in full of the district's bondholders, but the California Constitution and the Bankruptcy Court to date have ensured timely payment.

Reasons for Defaults

Generally speaking, defaults occur for at least one of the following reasons:

- General economic conditions are such that the municipality is unable to generate sufficient cash flow to pay its current obligations as they become due, and provide the type of services necessary for the continued operation of the municipal body. The "Proposition 13" mentality is one manifestation of the difficulties of continually increasing tax levies in order to pay for increasing costs of management service.
- Incompetent management of the municipal body that fails to increase revenues sufficiently to meet costs or to reduce costs below revenues.
- Fraud and dishonesty by municipal officials.

ANALYSIS OF PAST DEFAULTS

Defaults in the 19th Century

Between 1839 and the present, there have been in excess of 6,200 recorded defaults of municipal issues. The first recorded default was the city of Mobile, Ala., in 1839, which was a default on an issue in the principal amount of $513,000. Then, commentators were quite apologetic for the city, citing the panic of 1837 and two major fires in 1839 that resulted in a yellow fever epidemic as some of the leading factors that caused the default. When Mobile defaulted again in 1870, because of its speculation in financing of railroad supports through the use of municipal

funds, commentators more accurately and concisely stated that Mobile simply was unable to pay its debts.

During the 1850s and '60s, numerous states and municipalities failed to pay their debt obligations — Chicago, Detroit, Philadelphia and San Francisco, among them. One of the causes for such defaults was the excessive cost of municipal financing. Another reason for the municipal defaults was speculation by municipalities in real estate and other non-essential ventures.

A somewhat graver situation was the fact that in the 1840s, '50s and '60s, a number of states repudiated their indebtedness to bondholders; that is, they announced that they were no longer obligated to pay their debts and, in fact, refused to pay them. The first such repudiation was by Mississippi in the 1840s. In the following two decades, Florida, Alabama, North Carolina, South Carolina, Georgia, Louisiana, Arkansas, Tennessee, Minnesota, Michigan and Virginia also repudiated indebtedness. Such repudiation, along with the defaults that occurred in the 1800s, brought into question the security of investment in municipal obligations.[2]

Safeguards for Bondholders

As a reaction to the events described above, in the late 1800s and early part of this century, states enacted legislation to give bondholders greater rights and protection and to prevent unnecessary defaults on municipal obligations. The municipal bond market in effect mandated necessary changes in the documentation, legal authorization and structure of municipal financing, of which counsel should be aware. These included:

- debt limitation on municipal issuers to prevent excessive borrowing;
- clearly defined bondholder rights in the event of default supported by statutory and case law;
- use of bond counsel to determine the legality of the bond issue before the sale to avoid technical legal defects that could allow an issuer to repudiate the debt;
- development of credit-rating agencies as well as thorough credit review by investment firms and many institutional investors;
- statutory restrictions against municipal issuers borrowing for chronic deficiencies;
- the use of indenture trustees, paying agents and others who have certain fiduciary duties in order to protect the rights and interests of bondholders.

20th-Century Problems

While these safeguards are helpful, they obviously do not prevent all municipal defaults. During the 1930s' Great Depression, there were 4,770 municipal units that defaulted on some 9 percent of the then-outstanding total of $15 billion of municipal bonds. During the 1940s, there were 79 defaults by municipal bodies on indebtedness; during the 1950s, 112; and in the 1960s, 294.[3]

There currently exist a number of factors that will increase the difficulties for certain municipalities in meeting their municipal obligations as they become due. Among them are: the movement in both population and manufacturing capabilities from the snowbelt to the sunbelt; the urban decline and the need in the 1980s for major capital improvements; the increasing percentage of municipal budgets devoted to personnel-related expenses tied to cost-of-living increases; the Proposition-13 mentality among taxpayers; and the adverse effects of inflation, which have significantly increased costs of maintenance, repair and operation of a municipality beyond what was projected at the time many municipal obligations were assumed.

Just as defaults in the latter part of the 1800s and the beginning part of the 1900s brought about reforms in municipal financing that are now taken for granted, present defaults and the problems related to defaulted municipal bonds may lead to additional changes and safeguards in order to ensure that governmental bodies continue to have easy access to the credit markets. The "Ides of June" decision of the Washington Supreme Court[4] in 1983 held that the Washington municipal participants were not authorized under state law to enter into the participant agreements, and thereby eroded the basis for payment on the WPPSS Project 4 and 5 Bonds already issued. Due in large part to that fateful decision, there will be more frequent use of declaratory actions or confirmation proceedings prior to issuance of bonds to determine doubtful issues, and there will be little tolerance for those who issue bonds without resolving lingering legal problems.[5] This evolution is natural and good.

Types of Default

Defaults can be broken down into three main categories:

• *Defaults in the payment of principal and interest.* Usually indentures provide a grace period for a default in the payment of interest, but not for defaults in the payment of principal. Failure to pay interest may be caused by a temporary lack of cash flow, which could be cured within a short period of time without affecting the issuer's ability to pay the obligation.

• *Defaults affecting or impairing the security of the issue.* While most indentures don't provide for a default to occur when there is an impairing of the security for the issue, it is generally recognized that that may be a breach of the implicit terms of the indenture or bond resolution and, therefore, equitable remedies will be appropriate. For example, the security for the bonds would be impaired if the issuer, municipality or others took the position that the pledge of revenue, which is the source of payment for the issue, was somehow defective or contrary to state law and, therefore, illegal and void.

• *Other defaults of convenants contained in the bond ordinance or indenture.* This would include: failure to supply required documentation (e.g., financial records, certificates of compliance, and opinions of counsel); default under other indentures, resolutions, ordinances, agreements or other similar instruments of the municipality; proven material and untrue representations and warranties of the obligor relating to the issuer; insolvency, bankruptcy, receivership or incapacity of the obligor; judgments against the obligor over a certain amount that remain unsatisfied after the grace period; and failure to make reserve or sinking-fund payments.

Default v. Event of Default

In essence, a default is a breach or failure to perform an agreed-upon obligation, duty and responsibility by the issuing body. An "event of default" is the agreed-upon occurrence that allows the bondholders or their representative (indenture trustee) to take appropriate action, including the institution of the remedies set forth in the indenture.

The distinction between defaults and events of default is extremely important for counsel to consider, since most remedies are not triggered until the occurrence of an event of default. With certain exceptions, a default ripens into an event of default after notice has been made to the issuer for the commencing of the grace period and, after the lapse of time, the default remains uncured.

Normally, indentures provide that certain events — defaults in the payment of principal, proven material, untrue representations, voluntary bankruptcy of the municipal body, voluntary liquidation or receivership by the municipal body or others responsible for payment of the bonds — are of such a nature that there can be no prompt cure. No grace period is needed, and such defaults become events of default upon their occurrence. For example, after the decision of the Washington Supreme Court, upon the filing of a written interrogatory answer by WPPSS that it was unable to meet the Project 4 and 5 debt, Chemical Bank (the bond trustee) declared an event of default under the Project 4 and 5 documents. Defaults in the non-payment of interest, compliance with other convenants, reporting requirements or money judgments normally have a grace period provided before they ripen into events of default.

Counsel may determine that the grace period does not commence to run under the specific terms of the bond resolution of indenture until notice is received. (Notice is required to be given by a certain percentage of the bondholders — normally 25 percent — or the indenture trustee, if one is appointed.) However, it should be kept in mind at all times that bondholders who do not receive payment of principal or payment of interest may sue and take appropriate remedial action to correct such non-payment regardless of whether notices have been given.

The Three Phases of Default

The fact that a municipality may go into default does not necessarily mean that the municipality, its officers and agents are adversary to the interests of the bondholders, and that the interests of the bondholders are contrary to those of the municipality. Practice has shown that the interests of both the municipal body and the bondholders are virtually identical and not adver-

sary. It is the working out, in cooperation with counsel, of the municipal problem that is the best assurance to the bondholders that they will receive payment (as will be seen more specifically in the following analysis of the individual remedies), and it is in negotiating with the bondholders that the municipality is best able to find a cure and remedy for a very troubled financial situation.

Municipal officials must be mindful, in the default situation, that they will eventually have to return to the municipal market in the future to obtain credit. If the municipality does not treat the rights and interests of the bondholders in a proper manner, the municipality may foreclose — not only for itself, but also for many other similarly situated municipalities — the availability of credit.

There are three phases to the default situation, an understanding of which can aid counsel in assisting in communication and cooperation between the municipality and its bondholders.

Phase one — the gathering of all necessary documents and, if the pledge of certain revenues is defective or inappropriate, the taking by the municipality of appropriate action to cure that defect in order to prevent a default.

Phase two — the attempts to refinance, refund, work out and settle the problems that exist. It is during this period of time that the municipality and the bondholders or their counsel attempt to determine what methods can be employed to resolve the difficulties between them.

Phase three — the bondholders, or indenture trustee, proceed with acceleration, mandamus, litigation or collection of debt. This is the phase where, if the previous attempts to cooperate were not successful, both the municipality and the bondholders assume adversary positions in an attempt to protect their respective rights and interests. Normally, in general obligation and revenue municipal issues, the remedies provided in the documentation for the bond issue, along with the relevant case law and statutory law, will govern the rights and remedies of the bondholders. For conduit tax-exempt financing (such as industrial development, pollution control, health care facility bonds), in which there is recourse to collateral and, possibly, a private corporation, the available remedies are different.

ANALYSIS OF REMEDIES

Acceleration

Acceleration is the process whereby, upon occurrence of an event of default, a certain percentage (normally 25 percent or more) of the bondholders or the indenture trustee declare that the principal and all accrued and unpaid interest are immediately due and payable. Generally, acceleration is necessary if one desires to obtain: an increased interest rate, as may be provided for in the documents upon the occurrence of acceleration; or a judgment or deficiency judgment for principal and accrued and unpaid interest against the obligor.

Counsel should be aware that acceleration is not necessary for the commencement of equitable remedies, for the filing of a proof of claim in a bankruptcy proceeding or for seeking an appropriate non-accelerated remedy from a court.[6] For example, if a default consists of the failure of a municipality to comply with a convenant in the indenture (such as maintaining a certain ratio between tax revenues and existing obligations) that breach can be enforced through the institution of an appropriate legal action seeking to require the municipality to comply with the terms, and there is no need for acceleration.

Acceleration decreases the ease and ability of the municipality to cure a default. It is difficult to waive or annul the effects of acceleration of a widely held public issue, since a higher percentage of bondholders (50 percent or more) is normally required to rescind the acceleration than was required to initiate it (25 percent or, sometimes, less)

An attorney who is considering acceleration on behalf of bondholders would be well-advised that there are few benefits that acceleration will provide and many difficulties that it would create, and should consider the fact that, if the municipality is faced with paying immediately the full amount of principal and accrued and unpaid interest, that burden may paralyze the ability of the municipality ever to cure the default.

Institution of Lawsuit

Counsel for bondholders may institute a lawsuit requesting the municipality to take action, immediately pay all amounts due and owing to the bond-

holders or otherwise cure the default. These may be in the form of a suit for money judgment, mandamus, specific performance or other equitable relief.

A. *Request for Monetary Judgment.* Bondholders have a right to sue on their bonds for past due interest or principal without requesting the indenture trustee or any other party to take action.[7] A municipal body can take no action to seek a moratorium against suits by bondholders for past due principal and interest except the automatic stay that occurs upon filing a petition under Chapter 9 of the Bankruptcy Code.

In the case of *Flushing National Bank v. Municipal Assistance Corp.*[8] (which focused on the moratorium issued by the city of New York against payment and institution of lawsuits by noteholders), the highest court of the state of New York held in 1976 that the moratorium violated the contractual obligation of the municipality and the constitutional rights of the noteholders. The court held that the noteholders, whose principal and interest were due, had a right to bring suit and demand payment, and the municipality did not have the right to enjoin or stop such payment.

While sovereign immunity is a possible defense to suits to compel the payment of money from a municipal body, courts have generally held that, given statutory waivers of sovereign immunity or implied waiver by the municipality's entering into the debt obligation, bondholders' rights to commence action against a municipal body for payment of their debt should not be restrained.[9]

B. *Collection of Money Judgment.* A money judgment against a municipality is complicated by the fact that the courts generally do not allow the seizing of municipal property to pay its debts and obligations, since the seizure would disrupt local government.[10] Some courts have held that if there are funds that are surplus and not dedicated for any purpose, a bondholder may be able to attach and obtain those funds that are purely surplus and not necessary for the normal operation of the municipality. Likewise, in the absence of a specific statute authorizing a seizure of private property to satisfy a judgment on a defaulted municipal bond, there can be no remedy directly to the property held by the residents or inhabitants of the municipal body. There are some municipalities in several states bordering New York that had on their books provisions that allowed creditors of the municipal body to attach the property of its inhabitants.

C. *Mandamus Action.* Given the difficulties of collecting on a money judgment against a municipal body, attorneys representing bondholders of defaulted municipal bonds that are without recourse to specific collateral have other options. An available and most appropriate remedy is to proceed with an action in mandamus ordering the municipal body to increase taxes sufficiently to pay the obligations owed to the bondholders. (Mandamus, however, could not be used to require a municipal body to levy a tax that would exceed applicable constitutional and statutory limitations.)

Mandamus is "a command issuing from a court of competent jurisdiction requiring the performance of a particular duty therein specified, which results from the official station of the party to whom the writ is directed or from the operation of the law."[11] There are practical problems that may frustrate mandamus actions (such as vacancies in offices and resignation by municipal officers), since bondholders or the court do not have a right to cause such vacancies to be filled.

In one case, the governing board of a municipal body resigned when faced with an unfavorable determination in a mandamus action, and the bondholders were unable to obtain any remedies, since the court was without the power and jurisdiction to appoint new ministerial officers who could proceed to make the levy of taxes to pay the judgment so ordered.[12] In another case, there was a default since 1929 on a municipal bond issue, and a mandamus action was prosecuted successfully by the bondholders, only to have the municipal body refuse to make the levy of tax, even though the highest court of the state had affirmed the propriety of such levy as recently as 1973.[13]

A mandamus action can be rendered ineffective by either the resignation of the municipal officers and the failure to replace them, or by the general unwillingness of the municipal officers to carry out the court's order. The only alternative the court has if the munici-

pality refuses to proceed as ordered by the court is to hold such officers in contempt and render civil or criminal penalties. Depending upon the willingness of the municipality to cooperate, a judgment obtained against a municipal body through mandamus may be inefficient, and relief may be fraught with delay.

D. *Equitable and Declaratory Relief.* If there has been an improper expenditure by the municipal body, or if some other action is taken that impairs the security for the obligation, injunctive relief may be sought.[14] Moreover, if action is being taken that attacks the essence of the obligation, a declaration judgment action is appropriate to declare that a binding obligation exists. It should be apparent to counsel, given the problems inherent in the other forms of relief, that such equitable and declaratory action should be sought before resorting to other remedies.

Municipal Insolvency, Debt Adjustment

If a municipal body cannot pay its municipal obligations as they become due, it may consider proceeding to seek remedies under Chapter 9 of the Bankruptcy Code, 11 U.S.C. 01, et seq., "Adjustment of Debt of a Municipality." (A municipal debt adjustment resulting from Chapter 9 action is an adjustment based on a plan to pay creditors a reduced amount or a varied interest rate from what was originally bargained for, often over a longer period of time than was originally required.)

A Chapter 9 proceeding only can be instituted by the municipality's governing body or taxing body if the municipality does not have its own officials. And, unlike the corporate situation, it cannot be instituted by creditors involuntarily against the municipality. In order to initiate a Chapter 9 proceeding, the municipality must be duly authorized by state law or home rule power. The court in a Chapter 9 proceeding does not have the power, unless the municipality consents or a plan so provides, to stay, order, decree or otherwise interfere with any political or governmental powers of the municipality, any property or revenues of the municipality, or the use and enjoyment of any income-producing property.

Even if a court were to determine that a municipality was in fact insolvent and its revenues not sufficient to meet its current debt obligation, as a practial matter this determination would be of little help to the bondholders, since there will be certain necessary expenses in order to generate any revenues that a municipal body will have to incur. There would then be a significant question concerning whether liquidation of the municipal assets, in such an insolvency situation, would be in the best interests of the bondholders.

There is no authority for the proposition that poverty may be successfully interposed as a defense to the payment of lawful obligations. Some contend that it is more beneficial to be a judgment creditor rather than a mere bondholder if the municipality is later declared insolvent. However, given the new Chapter 9 provisions, it appears to make little difference whether one is a bondholder or a judgment creditor of a municipality.

Since governmental bodies were authorized in 1937 to effectuate municipal debt adjustment under federal bankruptcy laws, approximately 371 municipalities have instituted Chapter IX proceedings, involving less than $220 million of municipal debt. Since Oct. 1, 1979, and the new Chapter 9, only nine such proceedings have been filed. The reason for the sparing use of Chapter 9 is obviously that the stigma of bankruptcy is a heavy price to pay for the benefits of Chapter 9.

As a result of the sparing use of Chapter 9, there are a number of questions regarding municipal bankruptcy that need to be resolved. Some contend that Sec. 552(a) of the Bankruptcy Code provides that property acquired by a municipality after the commencement of the case is not subject to any lien resulting from a pledge entered into by the municipality prior to the commencement of the case.

However, most would contend that it would be contrary — both to the 10th Amendment and the very principles upon which the Municipal Bankruptcy Act of 1937 and Sec. 904 of the code were predicated — for a bankruptcy court to hold, pursuant to Sec. 552 of the Bankruptcy Code, that a pledge of revenues made by a municipal body — pursuant to a state authorizing that pledge or pursuant to a properly enacted bond resolution of that governmen-

tal body — can be terminated upon the institution of a Chapter 9 proceeding.[18] The treatment of bonded debt in the San Jose School District is consistent with the theory that the pledge survives bankruptcy.

In summary, counsel should be aware of the existence of municipal bankruptcy and the provisions of Chapter 9. However, counsel should also be aware that Chapter 9 is a remedy treated with such respect that it is seldom used, given the awesome ramifications of this action and the stigma of bankruptcy.

Use of Financing Authorities: Alternatives to Bankruptcy

Chapter 9 of the Bankruptcy Code was not intended as an exclusive remedy for municipal bodies that are unable to meet their current debt obligations. Since 1930, at least 15 states have provided for a state receiver or a state agency to act as a receiver when a local governmental unit defaults on its financial obligations. Counsel should not forget that a receivership is an available remedy that, given the enactment of appropriate legislation establishing a mechanism to control acrimonious lawsuits, allows bondholders and other creditors of the municipality to obtain the relief in a default situation.

It is state-created agencies such as a state agency for emergency municipal finance that have prevented a number of municipalities from having to seek relief under Chapter 9 and have allowed a number of troubled municipalities to work out their problems under state supervision, while providing to the bondholders the assurance that the amounts still owing to them will be paid. This was done in New York City in 1975-'76 with the creation of the Municipal Assistance Corporation, and in Chicago in 1980 with the creation of the Chicago School Finance Authority. Both these uses of consultants were approved by the highest court of the respective states. Consultants, financial advisors or financing authorities cannot alter the bondholders' rights and remedies without consent of the bondholders, and they cannot properly exercise the power of the municipal body. Similarly, they cannot have an improper delegation by the municipal body of its municipal powers.

Another mechanism available if a municipal body finds that its function or purpose has been eliminated is to petition the legislature for revocation of its chapter seeking an appropriate state court to supervise the liquidation of the municipal assets. This remedy is probably more appropriate for special tax districts and local governmental agencies that experience financial difficulties and where there is no current public purpose for their continued operation and existence (municipal hospitals, waste-treatment facilities, etc.).

Given the stigma many believe to exist with regard to a municipal bankruptcy (as demonstrated by its limited use in the last 46 years by only a few smaller municipal bodies), consideration should first be given to the use of state agencies, state receiverships, supervised liquidation of municipal assets or enactment of legislation establishing finance or refinance authorities (to issue debt to finance and refund existing obligations) as preferable alternatives to municipal bankruptcy.

Conduit Financing Remedies

When the debt is based upon tax-exempt conduit financing for industrial development or social benefits of a municipal body and its inhabitants — as in the use of industrial development bonds (IDBs) — there normally is provided an alternative source of recovery to the bondholders other than the governmental body's ability to levy taxes to pay off the indebtedness. In such cases, the collateral takes the form of the guarantee of the corporation and a mortgage or security interest in the collateral that is financed by such tax-exempt bonds. These financings are structured as revenue bond issues, and the municipal body is only liable for the indebtedness incurred to the extent it is paid to the municipality from the revenues generated by the project. In IDBs, the municipality is merely used as the "conduit" for the financing of a public purpose that has been approved by the municipal body.

Remedies available to counsel for the bondholders in conduit financings should not be directed against the municipality. The government officials, the bondholders or their representa-

tives should exercise their remedies against the collateral that specifically is pledged to pay the obligation, i.e., the facility that is being financed or the private corporation receiving the benefit. Normally, such remedies will be dependent upon the type of financing that was entered into and the types of remedies provided for in the specific documents.

Some specific remedies regarding conduit municipal financing are: a request for foreclosure and sale of the collateral;" non-judicial sale of collateral;" appointment of a receiver to manage trust property; suit against the guarantor; and the right to enter and operate trust property."

Filing Proof of Claim

Counsel for the bondholders may file a proof claim in bankruptcy for the amount of the bonds held. The indenture trustee has authority under most indentures to file a proof of claim on behalf of all bondholders, whether the bankruptcy be of the municipality or, in conduit tax-exempt financing, of the corporation that was liable on the bonds." The indenture trustee is not authorized to vote on a plan of reorganization or debt adjustment. However, the indenture trustee may object to plans of reorganization and should object to any plan that the indenture trustee knows is woefully inadequate or not appropriate.

A municipality in a tax-exempt conduit financing is not liable on the bonds except for payment from the revenue source pledged (lease payments or mortgage payments from the corporation), but has a fiduciary duty to the bondholders to file a proof of claim, if appropriate, or to object to any plan of reorganization that, in the opinion of the municipality, is not in the best interests of the municipality and the bondholders.

Security Fraud Action

A court has held that the 10th Amendment to the U.S. Constitution does not protect a municipality's issuance of industrial development bonds from the application of the federal securities law, since the issuance of bonds does not rise to the level of traditional governmental functions." There is a recent trend in the case law toward increasing the use of federal security fraud actions against issuers, underwriters and others, including municipalities." Numerous security fraud actions have already been filed by the holders of WPPSS 4 and 5 Bonds against various parties to the transaction. The best defense of such actions is the careful consideration of tax-exempt conduit financing at the time of approval in order to ensure that the bondholders and the municipality do not become victims of a prearranged scheme to defraud both of them.

Right to Select Directors Or Appoint Consultants

Some indentures provide that, upon default, the holders or the indenture trustee or the municipality have a right to select a majority of the board of directors or a certain number of directors of a private corporation. This provision is normally found in private placement conduit tax-exempt financing. Care is advised in exercising this option — the municipality should not be involved, and it should be left to the bondholders or indenture trustee to determine the most appropriate action. An important consideration is to ensure that the indenture trustee and bondholders are not control persons or insiders.

The use of consultants is helpful in structuring a workout or resolution of a defaulted revenue bond issue. There is a distinction to be noted between conduit issues and straight municipal issues, especially in revenue bonds for the financing of municipal utilities. It concerns the use of certain consultants to confer with the municipal body regarding the rates or taxes to be charged to such utilities customers. In giving consultants the power to approve decreases in rates and to recommend increases in rates, care should be taken to ensure that it does not constitute an improper delegation of the municipal body's powers.

Supplemental Indentures

Almost every indenture provides, and should provide, a mechanism to allow it to be supplemented or modified with or without the appropriate approval of the bondholders. Modification of indentures without the consent of the bondholders is only proper when the rights of the holders are not affected or when the modification gives additional security to the holders." Sup-

plemental indentures have been used successfully by counsel when the approval of the holders is necessary in order to resolve a defaulted issue and the proposal is deemed to be meritorious by the holders. If the municipality or indenture trustee is asked to be a party to a supplemental indenture, it should, before executing a supplemental indenture without the approval of the holders, seek advice of counsel concerning whether it is in compliance with the specific provisions of the indenture. A municipality or indenture trustee assumes liability for any damages arising out of the improper modification of an indenture.

Indenture trustees should be advised to seek approval of the holders for any supplemental indenture, except under specific, well-defined and undisputed instances when it is to correct an ambiguity, give additional security or benefit to the holders and does not impair any of the rights and interests of the holders.

Rescission of Acceleration And Waiver of Default

Sometimes the obligor, after being informed of acceleration of an issue, may be able to cure the default that causes acceleration, but may not be able to get the required approval of the bondholders to rescind the acceleration. Indentures should provide that acceleration, notice to sell collateral or the entry of a final judgment or decree against the municipality can be rescinded and annulled if the obligor pays all amounts due and owing, plus all fees and expenses of the indenture trustee and bondholders, provided all defaults have been cured and a majority of holders approve the rescission of the acceleration. As noted above, the fact that a majority of holders must approve rescission of acceleration indicates that acceleration in widely held public issues should be employed only with full knowledge of its consequences.

Acceptance of Default

In widely held public issues it may sometimes be impossible to get an appropriate percentage of holders to direct certain action to be taken to resolve a defaulted issue. Circumstances may be that the above remedies are inappropriate, and it is in the best interests of the holders to accept the default. Court approval of acceptance of default may be in the best interests of the municipality, the indenture trustee and the bondholders. Accordingly, in most difficult circumstances, counsel may well consider recommending to the holders or to the indenture trustee that, given the circumstances, they should accept the default and proceed with discussing a resolution without taking legal action. The only action necessary may be seeking court approval for the acceptance of the default.

Application of Proceeds

The indenture should have appropriate provisions with regard to how to disburse funds that are collected pursuant to the exercise of remedies. Normally, indenture provisions provide that such funds are to be disbursed as follows: first, to pay costs and expenses of the indenture trustee; then, to pay principal and interest due to the holders; and, if there is any surplus, to distribute it to the company or municipality. The funds collected for holders who cannot be located and are not known, as may happen in the case of municipal bonds not issued in registered form, cannot be paid as a windfall to known holders. Usually, any surplus money collected that cannot be distributed because the holders are not known or cannot be located goes either to the state or to the municipality.

Should Remedies Be Taken?

In considering remedies, it is always appropriate to be aware that there are times when it may be in the best interests of the holders, the municipality and its citizens to be patient and to refrain from proceeding to an immediate resort to remedies and litigation. Complete liquidation and acceleration of debt under certain circumstances may not be in the best interests of the bondholders and may adversely affect the municipality's ability to resolve the problem. A forced sale or acceleration in a conduit tax-exempt financing may, in certain circumstances, actually impair the security of the holders and cause them to recover less. Therefore, it is important in a default situation that the bondholders and others involved in the transaction have a clear understanding of the rights and remedies of the bondholders and a good assessment of the practical, financial realities with regard to proceeding to exercise those remedies.

In the San Jose School District situation, the debtor recognized its obliga-

tion to the bondholders. And although bankruptcy was viewed as a means of solving a labor problem, there was a recognition that the bondholders must be paid. In the far more complicated WPPSS situation, parties are still searching for a solution. However, it is clear that the continued viability of the municipal bond market is premised on the investors' confidence that they purchased valid and binding obligations and they will be repaid. Any solution to the WPPSS crisis, including a combination of any of the remedies set forth in this article, must be consistent with this premise.

There are times when litigation quite appropriately determines a serious pressing legal issue. There are other times, when, regardless of the merits of technical legal arguments, all parties must rise above the cloud of dust that hovers over the battlefield to see where the conflict is headed. At this juncture, it is difficult to determine where any particular defaulted bonds may be headed or who will prevail in any such battles over defaulted municipal obligations. However, there should be no lack of certitude as to who will eventually win the war if we desire to continue municipal financing as we presently know it.

---

(1) A detailed treatment of these topics by the author may be found in "Current Municipal Defaults and Bankruptcy 1983" (Practising Law Institute 1983).

(2) See generally Hillhouse, Albert M., "Municipal Bonds: A Century of Experience," Prentice-Hall Inc. (New York 1936); Feldstein, The Daily Bond Buyer, May 12, 1980, p.3 and 12.

(3) See City Financial Emergencies: The Intergovernmental Dimension, a Report of the Advisory Commission on Intergovernmental Relations (Washington, D.C., 1973); see also, Smith Barney, Harris, Upham & Co., Corporate Bond Research: Special Report dated April 26, 1978.

(4) Chemical Bank v. Washington Public Power Supply System, 666 P.2d 329 (Wash. 1983).

(5) See State ex rel Hall v. Taylor, 178 S.E.2d 48 (W.Va. 1970).

(6) See Oster v. Building Development Co., 252 N.W. 168 (Wis. 1934); Van Wesel v. McCord Radiator & Manufacturing Co., 20 N.Y.S.2d 91 (N.Y.Ct. 1939); Maynard v. Elliott, 283 U.S. 273 (1931).

(7) Mayo v. Fitchburg L. & St. Ry., 168 N.E.406 (Mass. 1929); Poage v. Co-Operative Publishing Co., 66 P.2d 1119 (Idaho 1937); Watts v. Missouri-Kan-Tex R.R., 383 F.2d 571 (4th Cir. 1967).

(8) 40 N.Y.2d 731, 390 N.Y.S.2d 22, 358 N.E.2d 848 (1976).

(9) State v. City of Lakeland, 16 So.2d 924 (Fla. 1944); Grant Constr. Co. v. Burns, 443 P.2d 1005 (Idaho 1968); Williams v. City of N. Las Vegas, 541 P.2d 652 (Nev. 1975).

(10) Barkley v. Levee Commissioners, 93 U.S. 258 (1876); E. McQuillin, The Law of Municipal Corporations (3d Ed. Rev. 1982) Vol. 17 Sec. 49.48.

(11) 17 McQuillin Sec. 51.02.

(12) See generally Barkley v. Levee Commissioners, supra.

(13) Water Users Association v. Board of Directors, 109 Cal. Rptr. 592 (1973).

(14) See Guardian Trust Co. v. White Cliffs Portland Cement & Chalk Co., 109 F.823 (8th Cir. 1901); Marine Midland Trust Co. v. Allegheny Corp., 28 F. Supp. 680 (S.D.N.Y. 1939).

(15) See eg. U.S. States Trust Co. v. New Jersey, 431 U.S. (1977); Davies v. City of Minneapolis, 316 N.W.2d 498 (Minn. 1982).

(16) Van Wesel v. McCord Radiator & Manufacturing Co., 20 N.Y.S.2d 91 (N.Y. Ct. 1939); Chicago Title & Trust Co. v. Chief Wash Co., 368 Ill. 146, 13 N.E.2d 153 (1938).

(17) There is a certain benefit having court approval, confirmation of the sale and sales price or, if necesary, rejection of all bids at a foreclosure sale. Rospigliosi v. New Orleans, M. & C.R.R., 237F. 341 (5th Cir. 1916), Provident Life & Trust Co. v. Camden & T. Ry., 177F. 854 (3d Cir. 1910); Kitchen Bros. Hotel Co. v. Omaha Safe Deposit Co., 254 N.W. 507 (Neb. 1934).

(18) See Sec. 9.03 of the American Bar Foundation, Mortgage Bond Indenture, 1981.

(19) In re Randolph-Wells Corp., 197 F. Supp. 227 (E.D. Ill. 1961).

(20) Woods v. Homes & Structures of Pittsburg, Kan., Inc., 489 F. Supp. 1270 (D. Kan. 1980).

(21) SEC v. Ferguson, Fed. Sec. L. Rptr. (CCH) para 4846.167; SEC Docket, Vol. 8, No. 2, p. 37.

(22) See Secs. 13.01 and 13.02 of the MBI.

(23) See Myers v. American National Bank and Trust Co., 277 Ill.App. 378 (1934).

(24) See Secs. 9.13 and 9.02 of the MBI.

(25) See Mayer v. Chase National Bank, 233 F.2d 468 (2d Cir. 1956).

(26) See R.M. Smythe & Co. v. Chase National Bank, 291 F.2d 721 (2d Cir. 1961).

Note: The lack of clarity in the reproduction of certain of the following appendixes is due to the unavailability of original copies.

The signing of the Buttonwood Agreement in 1792, which established the New York Stock Exchange.

CHAPTER 9 REFORMS ARE NEEDED

By James Spiotto of Chapman and Cutler

Present economic conditions, the "Proposition 13 mentality," and the recent outbreak of lawsuits requesting staggering judgments against municipalities have increased the probability municipalities will be face significant cash flow problems and ensuing financial crisis.

It has been estimated that the cost to municipalities for judgments or settlements in anti-trust, personal injury and civil rights actions has tripled in the past five years. Given this climate, a municipality may well consider instituting a proceeding for municipal debt adjustment under Chapter 9 of the Bankruptcy Code or face the inevitable acrimonious law suits injurious to the municipality and unproductive in providing either a solution to the problem or funds to pay its debts.

Present Use of Municipal Bond Financing and Future Needs Require Modification of the Bankruptcy Code.

According to recently released statistics, during the first quarter of 1985, the new issue volume of long-term municipal securities reached \$21.9 billion and the short-term volume was \$2 billion. A variety of public projects were financed by these bonds. For example, \$2.3 billion were used to finance educational facilities, \$1.1 billion were used for water and sewer facilities, \$2

billion were used for electric and gas operating projects. $3.5 billion were used for housing. $1.3 billion were used for hospital and health care facilities. $922 million were used for transportation, including roads, bridges, tunnels, ports, airports and transit systems. $746 million were used for economic development. $633 million were used for pollution control, and $390 million were used for other public purposes such as courthouse, jails and fire stations.

The United States contains the most extensive and sophisticated public works system in the world, including 3,866,000 miles of roadways, 565,000 bridges, 1,000 public mass transit systems, 16,000 airports, 25,000 miles of inland and intracoastal waterways, 70,000 dams, 900,000 miles of pipe in water supply systems, and 15,000 waste water treatment plants. Much depends on the efficient operation of these municipal facilities, most of which are financed by revenue bonds purchased by the municipal bond market.

The Congressional Budget Office estimates that the cost of meeting, on a nationwide basis, infrastructure needs will be $1.1 trillion dollars over the next twenty years. Only half of the cost is likely to be provided by federal government. More dra- [illegible] estimates of the infra- [illegible] Significant [illegible] state and local [illegible]

[illegible] condition of our present [illegible] structure and our [illegible] continued business growth and increase in jobs, there will be a rising demand on the [illegible] bond market to finance these infrastructure improvements over the next twenty years.

[illegible] markets are not static. They are as dynamic as the forces which push and shove the growth and development of this country. If there are uncertainties faced by municipal bond investors in purchasing municipal bonds due to interpretations of the present bankruptcy code which will be discussed below, then the market will begin to question the advisability of such investment. As a result, the market may either demonstrate greater selectivity in the obligations purchased or increase the cost of borrowing, both of which would most drastically affect those who most need financing.

The Increase of Municipal Financial Problems.

Over the past 150 years, various governmental bodies in the United States have fallen victim to financial crisis, including states, counties and municipalities. Such difficulties did not end with the Great Depression of the 1930s, and since the 1940s there has been an ever-increasing incidence of local government bodies either experiencing difficulties in meeting their financial obligations or defaulting on their municipal obligations. Between 1839 and 1969 there were 6,217 recorded defaults. Between 1945 and 1970, approximately $450 million of the principal amount of municipal bonds went into default, constituting 0.4% of the principal amount of outstanding municipal bonds in 1970. During the Great Depression (1929-1937) there were 4,770 recorded defaults. During the last thirteen years there have been at least 45 government defaults, including 9 on general obligation bonds.

Approximately 75% of all the defaults during the 1945-1970 period involved toll facilities: the default of the West Virginia Turnpike Commission ($133,000,000 in principal amount of revenue bonds); the

default of the Calumet Skyway ($101,000,000 in principal amount of revenue bonds); the default of Series C of the Chesapeake Bay Bridge and Tunnel Revenue Bonds ($100,000,000 in principal amount of revenue bonds.)

The default of the Washington Public Supply System Project 4 and 5 Bonds is the largest default of revenue bonds in history with more than $2,250,000,000 principal amount outstanding.

Generally, municipal debt adjustment has meant bondholders have been paid principal and interest, but over a longer period of time. There has generally not been a drastic reduction or forgiveness of the principal amount of the bonds. Since 1937, when the first constitutional federal municipal bankruptcy legislation was passed, there have been 357 cases filed involving municipal bodies. Between 1937 and 1972 there were 362 cases filed involving a total admitted indebtedness of approximately $217 million (albeit small in relationship to the total state and local outstanding indebtedness in 1972 of in excess of $174 million). The amount paid on such municipal bankruptcy debts exceeded $140 million and the amount of loss was approximately $77 million.

Between 1973 and October 1, 1979, there were nine bankruptcy cases filed by municipal bodies. From October 1, 1979 (effective date of the Bankruptcy Reform Act of 1978 (the "Bankruptcy Code"), there have been 16 cases filed under the new Chapter 9. It should be noted that there were more than 20,000 Chapter 11 (Corporate Reorganization) Petitions filed in the United States in 1984.

Municipal bodies have found less motivation and desire then their corporate counterparts to become involved in a bankruptcy proceeding, in part due to the stigma of bankruptcy and the questionable effect such would have on the municipality's ability to obtain financing.

Recent Municipal Bankruptcies and Threats of Bankruptcies.

The causes of recent municipal bankruptcies include large judgments which the local governments are unable to pay, other court actions, burdensome labor contracts, related real estate developments which went into private bankruptcy, changes in government structure, and poor financial planning.

Given recent legislative restrictions on taxation combined with the economic factor of increasing cost of providing minimal municipal services, municipalities face an increasing difficulty in meeting their debt obligation. Furthermore, municipal utilities which can be eligible to be debtors under Chapter 9 are faced with enormous pressure to avoid raising rates, although the costs of providing such services is increasing.

The reasons for the recent municipal bankruptcies are as varied as the units of local government themselves. South Tucson, for example, filed a petition pursuant to Chapter 9 when a large judgment was entered against it because od an accident suffered by a Tucson police officer. The petition filed by Bay City, Miss. was also motivated by a large personal injury judgment. The San Jose School District filed it could not meet what it considered to be onerous obligations pursuant to its labor contracts and an unfavorable labor arbitration award.

Wapanucka, Okla. filed for Chapter 9 relief after losing in a condemnation action to a property owner over a water well. Under Oklahoma law, judgments are paid from property taxes.

Chapter 9 would certainly have to be considered by municipalities faced with an annihilating judgment based on other theories of municipal liability. For example, an antitrust judgment involving the issue of city sewer service in the amount of $28.5 million dollars was entered against Grayslake, Ill., a town of only 500 people. Furthermore,

beleaguered utilities are discussing bankruptcy as a possible solution to their problems. Bankruptcy is still being considered as an option of the Washington Public Supply System in c... ing with its default bond liability on Projects 4 and 5.

The Historical Roots of Chapter 9.

During the 1970's, the experience of New York City and other troubled municipalities indicated that the prior federal bankruptcy statute was not a realistic option in that it provided no real solution to their problems. One of the states purposes of the current Chapter 9 of the Bankruptcy Code was to provide a workable procedure so that a municipality of any size that has encountered financial difficulty may work with its creditors to adjust its debts.

While there are some positive features, ambiguities in the Bankruptcy Code could have a disruptive effect on municipal finance.

Under the Bankruptcy Code, a Chapter 9 proceeding is a means of debt adjustment, not elimination of debts. Only a municipality may be a debtor under Chapter 9 [Section 109(c)(1)] and only a municipality may file a petition under Chapter 9 [Section 301]. Creditors of a municipality cannot institute involuntary proceedings. [See Sections 303 and 901(a)]. Chapter 9 is the exclusive Chapter under which municipalities can file.

Existing Code Provisions Have Created Lack of Confidence In Municipal Finance.

To a great degree, the current Bankruptcy Code is a product of bankruptcy lawyers who did not have extensive exposure to municipal finance. Therefore, although a sincere effort was made to provide municipalities with a workable vehicle for solving fiscal problems, a number of questions are raised by the existing legislation, including

1. Pledge of Revenues

Under Section 552 of the Bankruptcy Code, applicable to a Chapter 9, a lien terminates upon bankruptcy as to property acquired after the filing of a petition except for "proceeds, product, ETC." of property already subject to the lien. Various questions have been raised as to whether a pledge of municipal revenue and the lien created thereby will be terminated in a municipal bankruptcy due to the application of Section 552 to Chapter 9.

2. Preferences

Under Section 547 of the Bankruptcy Code, applicable to a Chapter 9, under certain conditions, payments by a debtor within 90 days of bankruptcy are voidable. Some have argued that a payment of pledged revenues by a municipality to bondholders within 90 days of filing would be preferential. Moreover, depending upon the time of the payments, payment to defease a bond issue could be argued to be preferential.

3. Transformation of Revenue Bond Issues Into A General Obligation.

Under Section 1111(b) of the Bankruptcy Code, a class of creditors may elect as a class to have their entire claim treated as secured by revenues or as with recourse. In the municipal context, such could transform a revenue bond issue into a general obligation of the debtor in violation of constitutional and statutory debt limitation.

4. Clarification of Municipal Insolvency

The traditional test of insolvency, that debts exceed assets, is misleading as applied to a municipal debtor. Many municipalities may be termed "insolvent" if assets exempt from attachment by state law are excluded. Further the definition of insolvency based upon the value of assets of a municipality is questionable since such a determina-

tion in susceptable to mere speculation given the nature of many municipal assets.

Sections 547, 552(a) and 1111(b) of the Bankruptcy Code, made applicable to Chapter 9 by Section 901, create uncertainty as to their application and hinder the ability of financially depressed municipalities to continue to obtain the financing needed to successfully work out of financial problems. As a practical matter, the application of Sections 547, 552(a) and 1111(b) of the Bankruptcy Code to Chapter 9 caused the following difficulties:

1. It is contrary to the idea of Federalism which was a premise to the Bankruptcy Code since these sections can be interpreted as terminating the pledges of revenue granted and guaranteed by state statutes and local ordinances.

2. It hinders and lessens the availability of bond financing to financially troubled municipalities by the uncertainty created by the preference provision, Section 547, and the termination of the pledge of revenues, Section 552. (These Sections decrease access to needed interim financing due to concerns about the municipality instituting a Chapter 9 proceeding which could impair Payments and Pledges made within ninety days of the date of filing and terminate the payment under a Pledge of Revenue after filing).

3. It will cause municipalities in practice to either refrain from the use of Chapter 9 or will require a municipality in a Chapter 9 proceeding to ignore the mandate of Sections 547, 552 and 1111(b).

4. It will prevent municipalities who use Chapter 9 from being able to obtain financing given the uncertainty of the application of Sections 547, 552 and 1111(b). Municipalities, especially small and medium size, will need extensive municipal financing during the next twenty years to fund needed infrastructure improvements and delayed maintenance while the same municipalities have experienced an erosion of their tax base, and the "Proposition 13" mentality requesting reduction in taxes.

Proposed Amendments To The Bankruptcy Code.

As presently drafted, the Municipal Bankruptcy Provisions of the Bankruptcy Code fail to take into account the realities of municipal finance. However, the Government Finance officers Association, National League of Cities, and the National Association of Bond Lawyers have proposed legislation which should solve numerous problems. To be effective, new legislation should include the following proposals:

1. Pledge of Revenues

Post petition effect security interest.

(a) Notwithstanding section 552(a) of this title and subject to subsection (b) of this section, special revenues acquired by the debtor after the commencement of the case remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

(b) Any such lien on special revenues other than municipal betterment assessments, derived from a project or system is subject to the necessary operating expenses of such project or system, as the case may be.

This new language would permit a lien on special revenues to continue under state law subordinate to necessary operating expenses of a project or system.

2. Preferences

"A transfer of property of the debtor to or for the benefit of any holder of bond or note, on account of such bond or note, may not be avoided under Section 547 of this title."

As a result, concerns about payments, defeasance or advance refundings as being preferential should be avoided.

3. Revenue Bonds As Recourse Claim

"The holder of a claim payable solely from special revenues of the debtor under applicable nonbankruptcy law shall not be treated as having recourse against the debtor on account of such claim pursuant of section 1111(b)."

The effect of this provision is that the holders of bonds which are contractually payable only out of revenues are deemed to

have made the election described in 1111(b)

4. Insolvency

"Insolvent"... means financial condition such that the municipality is generally not paying its debts as they become due unless such debts are the subject of a bonafide dispute."

Given the nature of municipal assets, this proposed amendment offer a more realistic test to determine if a municipality is insolvent. In addition, the groups are recommending other technical amendments designed to remedy the above-referred to ambiguities, including exclusion of pledged revenues from the effect of the "automatic stay" caused by the filing of a Bankruptcy Petition

PROPOSED MUNICIPAL BANKRUPTCY AMENDMENTS

Rev. 4/22/85

James W. Perkins, President of the National Association of Bond Lawyers, in connection witih the author, and the National League of Cities and Government Finance Officers Association have prepared the following municipal bankruptcy amendments.

SECTION 1. Section 109(c)(3) of title 11 of the United States Code is amended by striking the words "or unable to meet such entity's debts as such debts mature".

Comment: This amendment and the proposed S902(1) (see Section 3 below) go together. They make a general failure to pay debts the criterion for municipal insolvency and eligibility for filing. They replace the assets vs. liabilities test. The assets vs. liabilities test is not meaningful in the case of a municipality. See the Comment on proposed S902(1) below.

SECTION 2. Section 901(a) of title 11 of the United States Code is amended --

(1) by inserting "507(b)," after "507(a)(1)," and

(2) by inserting "1129(a)(6)," after "1129(a)(3),".

Comment: The superpriority provision of S507(b) should be applicable to municipalities, as it is to other debtors, where damage results from a stay or lien although adequate protection is required by S362 or 364.

Section 1129(a)(6) should apply to municipalities, as it does to other debtors, since municipal utilities are subject to rate regulation in a number of states.

SECTION 3. Section 902 of title 11 of the United States Code is amended --

(1) by redesignating clauses (2), (3) and (4) as (4), (5) and (6) respectively, and

APPENDIX C

(2) by inserting new clauses (1) and (2) as follows:

"(1) 'insolvent', notwithstanding S101(29), when used in a section that is made applicable in a case under this chapter by section 103(e) or 901 of this title, means financial condition such that the municipality is generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute."

"(2) 'special revenues' means (a) receipts derived from the ownership, operation or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems, (b) special excise taxes imposed on particular activities or transactions, (c) incremental tax receipts from the benefited area in the case of tax-increment financing, (d) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions, (e) taxes specifically levied to finance one or more projects or systems, but not including (except for tax-increment financing) receipts from general property, sales or income taxes levied to finance the general purposes of the debtor."

Comment: Section 101(26) defines insolvency as debts exceeding the fair value of assets. Many municipal assets are special-purpose assets and have a highly uncertain market value, which is probably less than cost. Under these circumstances, many healthy municipalities would be treated as "insolvent". Also many municipal assets cannot be reached to pay debts, rendering the assets vs. liabilities test somewhat irrelevant to creditors. This amendment uses a more realistic test to determine whether the municipality is insolvent. It is the same as that applicable to involuntary bankruptcy under Section 303(h)(1). The change in S109(c)(3) (above) is correlative to this change.

If a department of a municipality is financed by indebtedness payable solely from revenues attributable to that department a general failure to pay such indebtedness as it becomes due would, if it is substantial in amount, cause the municipality to be considered insolvent.

The present tense in the definition of "insolvent" refers to the time at which the definition is important, i.e., at the petition date for purposes of S109(c), at the transfer date for purposes of S547, and the like.

A deliberate failure to pay indebtedness in order to create eligibility to file a petition under this chapter would be grounds for dismissal under section 921(c).

The definition of special revenues is needed for the purposes of revised sections 922, 925 and 927.

Examples of the special revenues mentioned in clause (a) include receipts from the operation of a municipal water or electric system.

An excise tax on hotel and motel rooms or the sale of alcoholic beverages would be a special excise tax under clause (b). A general sales tax would not.

In a typical tax-increment financing public improvements are financed by bonds payable solely from and secured by a lien on incremental tax receipts resulting from increased valuations in the benefited area. Although these receipts are part of the general tax levy, they are considered to be attributable to the improvements so financed and are not part of the pre-existing tax base of the community.

Examples of revenues from particular functions under clause (d) would include regulatory fees and stamp taxes imposed for the recording of deeds.

Under clause (e) an incremental sales or property tax specifically levied to pay indebtedness incurred for a capital improvement and not for the operating expenses or general purposes of the debtor would be considered special revenues. For this purpose a project or system may or may not be revenue-producing.

SECTION 4. Section 922 of title 11 of the United States Code is amended by adding a new subsection (c) as follows:

"(c) The filing of a petition under this chapter does not operate as a stay of application of pledged special revenues in a manner consistent with section 927 of this title to payment of indebtedness secured by such revenues."

Comment: Where a pledge of revenues survives under Section 927, it would be needlessly disruptive to financial markets for the effectuation of the pledge to be frustrated by an automatic stay.

SECTION 5. Section 925 of title 11 of the United States Code is amended --

(1) by adding to the section heading the following: "and certain secured claims";

(2) by striking out "A" and inserting "(a) A" in lieu thereof; and

(3) by adding a new subsection (b) to read as follows:

"(b) The holder of a claim payable solely from special revenues of the debtor under applicable non-bankruptcy law shall not be treated as having recourse against the debtor on account of such claim pursuant to section 1111(b)."

Comment: Section 1111(b) provides that in some circumstances non-recourse debt may be treated as recourse debt. Many municipal obligations are, by reason of constitutional, statutory or charter provisions, payable solely from special revenues. This amendment leaves these legal and contractual limitations intact without otherwise altering the provisions with respect to non-recourse financing.

SECTION 6. Section 926 of title 11 of the United States Code is amended --

(1) by inserting "(a)" before "If"; and

(2) by adding a new subsection (b) as follows:

"(b) A transfer of property of the debtor to or for the benefit of any holder of a bond or note, on account of such bond or note, may not be avoided under section 547 of this title."

Comment: In the case of a municipality it is not considered necessary to legislate broadly against preferential treatment of bond and noteholders. There is not likely to be a high incidence of preferential treatment of these creditors and, where there is an actual intent to hinder, delay or defraud other creditors, section 548 would apply. The existing law, under which section 547 applies to municipal bonds and notes, creates unforeseen problems and uncertainties. For example, most municipal revenue bonds involve a pledge of special revenues but do not include a mortgage or other security interest on any revenue source. The application of section 547 to them could cause payments of such bonds in the normal course to be treated as preferences since the lien on revenues received

during the preference period would be treated as coming into existence during the preference period and not before. In addition, the deposit of money or securities in escrow to "defease" the lien of a prior bond indenture, which is a common occurrence, could also be treated as a preference notwithstanding the absence of any preferential intent or actual damage to other creditors.

SECTION 7. Section 927 of title 11 of the United States Code is redesignated as section 929.

SECTION 8. Title 11 of the United States Code is amended by adding new sections 927 and 928 to read as follows:

"§927. Post-petition effect of security interest.

(a) Notwithstanding section 552(a) of this title and subject to subsection (b) of this section, special revenues acquired by the debtor after the commencement of the case remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

(b) Any such lien on special revenues, other than municipal betterment assessments, derived from a project or system is subject to the necessary operating expenses of such project or system, as the case may be.

Comment: If deemed to apply, Section 552(a) could terminate the security for municipal revenue bonds upon commencement of the case where (as is usually the case) there is no mortgage or security interest on any revenue source. Paragraph (a) makes it clear that such a result is not intended. It permits a lien on special revenues to continue under state law but, under paragraph (b), a lien on project or system revenues would be subordinate to necessary operating expenses of the project or system. Necessary operating expenses are operating expenses which are necessary to keep the project or system going. Pre-petition operating expenses are included to the extent payment is deemed necessary by the court for this purpose.

In the case of a project financing the lien would be subordinate to the necessary operating expenses of the project. In the case of a system financing the lien would be subordinate to the necessary operating expenses of the system. An example of a project financing would be the financing of an electric generating plant by indebtedness secured by a lien on revenues

from the sale of output of the particular facility. An example of system financing would be the financing of improvements to a local electric distribution system secured by a lien on revenues of the entire system.

Subsection (b) reflects the fact that betterment assessments are levied to finance the construction costs of sewers, streets and the like and that the operating costs are financed separately out of current user charges or taxation. In the case of bonds secured by these assessments, subordinating the lien to operating expenses would materially change the bargain.

Subsection (b) sets forth a minimum standard for paying operating expenses ahead of debt service where revenues are pledged. It is not intended to displace any broader standard contained in the terms of the pledge or applicable nonbankruptcy law.

S928. Municipal Leases. Notwithstanding section 365(m) of this title, a lease to a municipality shall not be treated as an executory contract or lease for the purposes of sections 365 and 502(b)(6) solely by reason of its being subject to termination in the event the debtor fails to appropriate rent.

Comment: For reasons unique to municipalities, many financing leases are required to be subject to appropriation of the rent. These are generally marketed as debt obligations and treated as debt obligations for tax purposes. They should be treated in the same way for bankruptcy purposes.

SECTION 9. Section 943(b) of title 11 of the United States Code is amended by:

(1) striking "and" from clause (5)'

(2) renumbering clause (6) as clause (7); and

(3) inserting a new clause (6) as follows:

"(6) any regulatory or electoral approval necessary under applicable nonbankruptcy law in order to carry out any provision of the plan has been obtained, or such provision is expressly conditioned on such approval; and"

Comment: Many municipal actions require regulatory or electoral approval under constitutional, statutory or charter provisions. These approvals are not limited to rates but extend often to such other matters as the acquisition or disposition of property or the incurring of indebtedness. A plan of adjustment should not call for action to be taken without the

requisite approval. Clause (6) does not require voter approval for the plan but only for actions to be taken under the plan which would require such approval if taken otherwise than under the plan.

CAN THE CITY OF EVERBRIGHT SURVIVE: DEFAULT AND LIABILITIES

A CASE STUDY

I. FAILED MUNICIPAL ELECTRIC PROJECT.

A. City Attempts Bailout.

CITY OF EVERBRIGHT ("City") which is located on the shores of the Everflow River has issued Bond Anticipation Notes ("BANS") for the purpose of acquiring certain lands and construction of a hydroelectric generating facility called the Everflow Project. The BANS in the amount of One Hundred Million Dollars ($100,000,000) have a maturity date of December 1, 1985. Funds sufficient to pay interest up to December 1, 1985 have been placed in an Interest Reserve Fund. The Project is partially completed and is doomed to failure due to a faulty feasibility study and construction costs far in excess of budget. The City is not able to complete the Project. A private utility, New Hope Company ("New Hope") has proposed to the City a lease of the Everflow Project, provided New Hope obtains transfer of the FERC license to New Hope and certain Real Estate Tax Benefits. The City is willing to offer New Hope a long-term lease in an attempt to solve the City's problem. The long term lease by New Hope will provide over time a payout of $110,000,000 gross to the City. The Lease has a present value of $90,000,000. The City, threatened by lawsuits, including a security fraud action from BANS Holders, proposes to pay BANS in full ($100,000,000) by issuing General Obligation Bonds in that amount rather than Revenue Bonds. The Holders of the BANS have a Pledge of the Revenue from the City's Power and Light Department and the Everflow Project.

B. Lawsuit to Prevent Bailout of BANS by GO Bonds.

A local citizen who has been opposed to the Project from the start, Charles Anger, proceeds to go to court to file a lawsuit enjoining the issuance of General Obligation Bonds on the grounds that such an Issue is unconstitutional in that it constitutes the lending of credit from the Municipality to the private corporation and that the developer should purchase the property from the city at fair-market value which Anger contends is in excess of $100,000,000. Anger, a self made capitalist, further contends the Note Holders should suffer any loss if the proceeds from the sale of the Project to the private developer are insufficient to pay the BANS in full.

C. Moratorium and BANS Holder Protective Committee.

Given the delay in issuing GO Bonds to pay off the BANS the City and State Legislature passed a moratorium Resolution prohibiting lawsuits on the BANS due to the impending GO Bond sale. Undaunted by this action, the BANS Holders proceed to file throughout the country various lawsuits claiming "security fraud" since the feasibility study which accompanied the official statement indicated that the Project was

APPENDIX D

feasible, and that the City intended and was capable of completing the Project on schedule and below cost. It appears the Mayor and certain other of the City officials proceeded to employ relatives and political friends who worked on the Everflow Project at what amounted to be very favorable no bid contracts. The Securities and Exchange Commission instituted an investigation surrounding the issuance of the BANS and the local United States Attorney was investigating the matter and is expected to come down with indictments shortly.

D. Power Purchase Contract.

The City in order to ensure continued electrical power for its citizens enters into a Power Purchase Contract with the City of Sunlight (hereinafter the "Sunlight Contract"). Their contract obligation is required to be sufficient to pay off in full all debt service on the City of Sunlight Revenue Bonds Series of 1980 A in the principal amount of $100,000,000. The BANS Holders file a lawsuit contending that the Operation and Maintenance Expense ("O&M expense") payment on the Purchase Power Contract should not come before payment on the BANS. Citizen Anger files a lawsuit questioning the "take or pay" aspect of the Power Purchase Contract as constitutionally prohibited debt and the statutory authorization for the City of Everbright to enter into this Contract. The Sunlight Revenue Bonds Series 1980A are due in 1990 when the Power Contract expires and after the Everflow Project was scheduled for completion.

II. AFFLUENT REVENUE BONDS.

A. Diversion of Pledged Revenues.

The City has issued One Hundred Million Dollars ($100,000,000) worth of Revenue Bonds towards a Sewer-Waste Water Treatment Facility ("Waste Revenue Bonds"). Despite the economic downfall of the Everflow Project of the City, the outlying area is booming and numerous other surrounding municipalities use the Sewer-Waste Water Treatment Facility. Accordingly the coverage of revenues to debt service exceed all projections. Since the City desperately needs money to pay maintenance and ongoing cost of the Everflow Project, the Mayor takes Revenues which were pledged to the Sewer-Waste Water Revenue Bondholders and diverts them to the General Fund of the City in an attempt to pay the costs associated with the failed Everflow Project including contract payments to his relatives and friends.

B. Discovery and Bondholder Action.

One of the Waste Revenue Bondholders is also an employee for the Sewer-Waste Water Treatment Facility and becomes aware of the diversion of funds. This employee contacts other friends who purchased the Waste Revenue Bonds. They form a Bondholder Protective Committee and consult with a local attorney concerning what causes of action they have against the City, the Mayor, his relatives and others for the diversion of pledged revenues from the Sewer-Waste Water

Treatment Facility to the General Fund of the City. To date the Waste Revenue Bondholders have been paid interest in accordance with the scheduled Interest Payment dates. The Revenues are more than sufficient on a projected basis to pay all debt service due and owning.

III. CONSIDERATION OF THE CITY FILING A CHAPTER 9 PROCEEDING.

The Mayor, plagued with both personal and municipal problems, consults a local attorney as to whether a Chapter 9 Bankruptcy Proceeding would help the City's present financial problems and legally allow the City to divert revenues from a very profitable Sewer-Waste Water Treatment Facility to general municipal uses. The Mayor has heard stories that Congress was attempting to prevent diversion of pledged revenues in a Chapter 9 proceeding on a prospective basis and the Mayor desires to take full advantage of Chapter 9 before any such corrective legislation takes effect.

IV. DEFAULTED INDUSTRIAL REVENUE BONDS.

A. IRB Bonds.

Also in downtown Everbright, there is a hotel and shopping center which was to be the promise of prosperity to the City. Unfortunately, the failure of the City to complete an Urban Development Project and the accompanying dust, construction noise and general disturbance to downtown Everbright has caused the shopping center to lose significant business. The City had issued Twenty Five Million Dollars ($25,000,000) in Industrial Revenue Bonds to pay for the acquisition and construction of the facility, $10,000,000 for the hotel and $15,000,000 for the shopping center. A private corporation Best Bed, Inc. ("Best Bed") has leased the hotel and Best Buy Retailer ("Best Buy") has leased the shopping center. Both Best Bed and Best Buy are wholly owned subsidiaries of B.B. Company ("BBC") which is guarantor of the IRB Bonds and has leased the Property from the Industrial Development Authority of City and in turn sub-leased it to Best Bed and Best Buy respectively.

B. Default of Best Buy.

Best Buy is a complete failure and has failed to make its monthly lease payment. Best Bed is a complete success. It appears national conventions desire the site because all who attend must stay at the Convention Center since there is absolutely nowhere else to go. The Indenture Trustee made the last interest payment of the Interest Reserve Fund on May 15, 1985 and does not have enough funds to make the November 15, 1985 interest payment. Sufficient funds are due 10 days prior to the interest payment date under the terms of the lease and Mortgage Indenture. The Indenture Trustee has given notice of default and has threatened foreclosure against Best Buy and Best Bed.

C. Best Buy Files Bankruptcy.

Best Buy which leases the shopping center files a Chapter 11 Proceeding and informs the City that the Debtor no longer can make the payments on the IRB Bonds given the automatic stay provision of the Bankruptcy Code. Best Buy gives notice of rejection of the lease. New Hope which is interested in purchasing the Everflow Project, which is incomplete, has offered to purchase the shopping center at a discounted value. New Hope's offer is sufficient to pay a portion of the IRB Bond debt service if the lease payments to Best Bed are increased 15%. Meanwhile, the hotel seems to be able to attract significant business, is profitable, and able to pay more than its share of the lease payments. B.B. Company objects to the New Hope's offer since there is nothing in it for B.B Company and claims that it will cause tax problems and any increase in Best Bed's lease payments would be an impairment of its contract by the City.

V. *ANTITRUST LAWSUIT.*

Meanwhile, Citizen Anger, and certain other landowners in the City have banded together and desire to convert their extensive landholdings on the outskirts of the City to a shopping center/convention center, which would be in direct competition with the somewhat blighted Urban Development Project downtown and threaten the recovery of the faltering IRB Project. The City, given the troubles it is experiencing with the Everflow Project and the IRB Project, refuses to give citizen Anger a change of zoning from agricultural to commercial which is necessary for the shopping center/convention center. He proceeds to file a lawsuit charging an anti trust violation in zoning and obtains a Fifty Million Dollar ($50,000,000) judgment against the City.

VI. THE CITY FILES A CHAPTER 9 PROCEEDING.

Given all of the pending litigation and economic adversities, the City decided to file a Chapter 9 Proceeding. Within 90 months of the date of filing City has made, inter alia the following payments:

<u>Payments Within 90 days of Chapter 9 Petition:</u>

1.	**Waste Water Treatment Bond**	**$3,000,000**
	Holders Interest & Sinking Fund	**$6,000,000**
2.	**G.O. Bond Holders**	
	Interest	**$9,000,000**
	Payment out of Reserve Funds (held by Indenture Trustee for more than 90 days prior to filing Chapter 9)	**$10,000,000**
	Sinking Fund	**$7,000,000**
3.	**BANS - Everflow Project**	**$10,000,000**
4.	**Salary of Municipal Employees**	**$10,000,000**
5.	**Pension Fund Project (Deducted from Payroll checks)**	**$3,000,000**
6.	**Power Purchase Contract payment (paid from funds collected and put into a Revenue Account more than 90 days prior to filing)**	**$10,000,000**

The City has projected its annual Revenues without increasing taxes and Annual Expenses without cutting services for the next 4 years as follows:

City of Everbright

Projected Annual Revenue Sources

Sewer Waste Treatment Facility	**$60,000,000**	
Real Estate	**$45,000,000**	**95% of Constitutional Debt Limit**
Sale Taxes	**$32,500,000**	
City Income Tax	**$25,000,000**	
License, Fees and others	**$12,500,000**	
Municipal Power & Light	**$25,000,000**	**(Power Purchase Contract Sales)**
Total Revenues	**$200,000,000**	

Projected Annual Expenses

Essential Municipal Services and (Police, Fines, Roads and Administration)	**$95,000,000**
Amount set aside for Debt Service	**$35,000,000**
Sewerage Waste Treatment Facility	**$40,000,000**
Power Purchase Contract Obligations	**$20,000,000**
Everflow Project Costs (Maintenance-non construction)	**$ 10,000,000**
	$200,000,000

The City files its Schedule of Creditors under Section 925 of the Bankruptcy Code and lists the following Major Creditor Groups.

Creditors as of Date of Filing Chapter 9	
Municipal Employees (Wages - 80% under $2,000)	$1,000,000
Municipal Employee Union (pension payment)	$15,000,000
Trade (Accounts payable)	$20,000,000
General Obligation Bond Holders	$150,000,000
Waste Water Facility Revenue Bond Holders	$100,000,000
BANS - EverFlow Project	$100,000,000
Power Purchase Contract	$60,000,000
Anger Anti Trust Judgment	$50,000,000
Total Debt	$496,000,000

Discussion Questions:

1. Can the City issue GO Bonds to pay for Bond Anticipation Notes in connection with a Project which the City intends to lease to a private utility as opposed to a public corporation?

2. Does Citizen Anger's lawsuit have any merit regarding the unconstitutional Lending of Credit?

3. What remedies do the Bond Anticipation Note Holders have with the impending inability of the City to pay.

4. Do the Noteholders have to wait until a missed interest or principal payment in order to bring a lawsuit with regard to Bond Anticipation Notes?

5. What causes of action do the Noteholders have against the Mayor for the unfavorable no bid contract which led to the demise of the Everflow Project?

6. Can the City require Anger to post a Bond for damages and losses suffered due to the delay in the issuance of the GO Bonds caused by his lawsuit? Should Charles Anger win his lawsuit?

7. Can the City lease the Everflow Project to New Hope? Is the City required to sell the Project at the highest and best price at an auction sale? What, if anything, do the BANS Holders get from the proceeds of sale or lease of the Project?

8. Can the BANS Holders maintain federal securities fraud lawsuits or RICO lawsuits against the City, Mayor or others?

9. What jurisdiction does the SEC have over the BANS Issue?

10. Can the State and City issue a moratorium which prevents lawsuits due to the impending GO Bond Issue?

11. Is the diversion of surplus revenue from the Waste Water Treatment Facility to the General Fund of the City a default as to the Revenue Bondholders?

12. What remedies do the Waste Revenue Bondholders have?

13. If the City goes into bankruptcy can the City use the revenues generated by the Water and Sewer taxes for general municipal purposes?

14. Are the payments made to the Noteholders and Bondholders within 90 days of the date of initiating a Chapter 9 proceeding a voidable preference which must be repaid to the City. What if the payment were made from a Reserve Fund?

15. Does the Pledge of revenue to the Waste Revenue Bondholders terminate upon the institution of a Chapter 9 proceeding?

16. Does the use of revenues from the Waste Water Treatment Facility, which are pledged to the Revenue Bondholders, allow the Revenue Bondholders to elect to transform the Revenue Bonds into General Obligations under Section 1111(b) of the Bankruptcy Code?

17. What remedies do the Revenue Bondholders have against the City to prevent the diversion of funds?

18. Can the City successfully contend that the transfer of revenue from the Waste Water Treatment Facility is permitted since there is more than enough revenue being generated by that Facility in excess of the amount required by the terms of the Bond Resolution?

19. If Best Buy goes into bankruptcy, what is the amount of the claim the Industrial Revenue Bondholders have against Best Buy?

20. Can the claim of the Bondholders be limited to a claim on a real estate lease under Section 502(b)(7) of the Bankruptcy Code?

21. Is Section 502(b)(7) applicable to an Industrial Revenue Bond Issue?

22. If a private corporation which has leased property from the City goes bankrupt what are the remedies available to the municipality?

23. What duties does the issuing municipality have to the Holders of Industrial Revenue Bonds to protect the rights of the Bondholders?

24. What are the remedies available to the Indenture Trustee and IRB Bondholders?

25. If the shopping center was sold what happens to the funds deposited with the Indenture Trustee for the Industrial Revenue Bonds? Is this an "After Born" Sinking Fund?

26. What effect does an "After Born" Sinking Fund have on the tax exempt status?

27. If New Hope purchases the Industrial Revenue Bond Project, would the assumption of the obligation of the Bonds require new TEFRA hearings?

28. If the Municipality raises Best Bed lease payments by 15% due to the New Hope Purchase and workout is that an impairment of Best Bed's contract rights?

29. If New Hope desires to change the interest rate, principal and maturity of the Bonds would that alter the tax exempt status?

30. What are the present limitations on suit by private individuals against a municipality on antitrust grounds arising out of zoning?

31. Will current legislation change the result of Citizen Anger's lawsuit?

32. If the City was to file a Chapter 9 proceeding, could the City issue judgment bonds to pay off the judgment of Citizen Anger?

33. In a Chapter 9 proceeding, can the City avoid the obligation to pay Citizen Anger on his antitrust judgment?

34. What remedies does Citizen Anger have to collect on his judgment?

35. In a plan of adjustment in a Chapter 9, what are the priorities between the Power Purchase contract obligation and the Ever Flow project BANS?

36. What are the priorities between payment of debt service in a Chapter 9 proceeding on Revenue Bonds such as the Sewer Waste Treatment Facility Revenue Bonds and General Obligation bonds?

37. Can funds be diverted from payment of essential municipal services to the payment of General Obligation and Revenue Bondholders in a Chapter 9 proceeding?

38. Will General Obligation Bondholders and Revenue Bondholders in a Chapter 9 proceeding receive scheduled debt service payment?

39. Given the listing of payments within ninety days of the City's filing a Chapter 9 petition, which of those payments are preferences and which are not?

40. Can the City of Sunlight Revenue Bondholders, Series 1980A which has a pledge of the payments under the

Power Purchase Contract claim that they are an Operation and Maintenance expense senior to other creditors of the City of Everbright's Power and Light Department, including the Holders of the BANS?

41. Can Charles Anger, a citizen of the City of Everbright, successfully challenge the Power Purchase Contract entered into by the City of Everbright and the City of Sunlight on the basis that the "take or pay" obligation is unconstitutional as an impermissible debt of the City of Everbright?

42. What defenses does the City of Everbright have with regard to any lawsuit filed by the City of Sunlight Revenue Bondholders for payment prior to Everbright's from revenues generated from the City's Power and Light System?

43. Given the revenues available to the City of Everbright and the nature of the City's creditors, what Plan of Adjustment would be appropriate in this case?

ALL-AMERICAN STEEL CONDUIT FINANCING

A. The Financing.

Industrial Development Bonds in the amount of \$25,000,000 of the Industrial Development Board of the City of Promise, U.S.A., Industrial Revenue Bonds (All-American Steel, Inc. - Project 1) 8% Term Bonds were issued pursuant to a Mortgage and Indenture of Trust as of July 1, 1975 and Industrial Development Bonds in the amount of \$75,000,000 of Promise, U.S.A., Industrial Revenue Bonds (All-American Steel, Inc. - Project 2) 10% Term Bonds were issued pursuant to a Mortgage and Indenture of Trust dated as of December 1, 1977 (Both Issues are sometimes referred to collectively as the "Bonds".). Under the Indentures, payment of the Bonds is secured by first mortgages on the real property, buildings, machinery and equipment of the respective Projects. The Projects are leased by the Industrial Development Board of the City of Promise, U.S.A. to All-American Steel, Inc. ("All-American"). The respective lease payments were to be sufficient in amount to insure the prompt payment of principal and interest on the respective Bonds, and the lease payments are pledged to the payment of the principal and interest on the respective Bonds.

B. Bankruptcy of All-American.

All-American encountered severe financial difficulties. Project 2 (an ore reduction facility) has been mothballed; Project 1 (a finishing mill) is operating on a reduced basis. On October 1, 1983, All-American filed a Petition under Chapter 11 of the Bankruptcy Code. All-American failed to make required Lease Payments and the Indenture Trustees gave Notices of Default to the Debtor. Such Notices of Default are conditions precedent to accelerating the principal and interest due on the Bonds. Counsel for the Debtor has taken the position that such Notices of Default and intent to accelerate violated the automatic stay provisions of S362 of the Bankruptcy Code and were void ab initio. Nevertheless, All-American did not act to reject or assume the Leases in Bankruptcy. Moreover, it appeared that the value of the Projects, as terminated and not as going concerns, would not be sufficient to pay off the amount due on the Bonds.

C. Dilemma of the Bondholders.

There was no Guaranty by All-American of the Bonds. All-American is only liable on the Leases. Section 502(b)(6) of the Bankruptcy Code arguably could limit the exposure of All-American to the greater of one year or 15% not to exceed three years of the remaining term of each Lease, following the earlier of the date of filing the Petition or the date on which the Lessor repossessed or the Lessee surrendered the leased property. Such treatment would be contrary to the "Financing Lease" nature of Conduit Financing. At least one court, In re Winston Mills, 6 B.R. 587 (S.D.N.Y. Bankr. Ct. 1980) has held that Industrial Revenue Bond financing, though a lease mechanism, was in fact a Financing Lease and not a real estate lease

subject to §502(b)(6) of the Bankruptcy Code. Further, All-American has not paid any use and occupancy on the Project 1 Lease even though All-American has operated the plant for over a year under Chapter 11.

D. <u>Possible Rehabilitation of All-American.</u>

All-American takes the position that in 1982 the ore and Project costs of operation were such that it would cost almost twice the sales price per pound to produce steel. Part of this problem is due to unfavorable labor and power contracts which All-American has entered into. All-American is a joint venturer with two other companies in an aluminum reduction plant which can be operated at a profit. Accordingly, the closing of Project 2 had little adverse effect on All-American and, in fact, turned out to be beneficial. Creditors of Project 2 (Trade and Public Debt) must consider what action should be taken to force All-American to either operate Project 2 or pay the obligation due thereon.

E. <u>Debtor Plan for Project 2.</u>

The market appears to be improving, and it appears that, in time, if labor and power contracts can be renegotiated favorably to All-American that Project 2 would be a profitable and necessary operation. Trade and Public Debt may join forces to attempt to force a prompt opening of Project 2, but the Debtor attempts to solicit the aid of Public Debt in negotiating the labor contract. Further, the Debtor may attempt an early cram down of Public Debt in order to aid in the future viability of the Company by reducing the amount the Debtor may have to pay for an asset which presently has a reduced value but in the future will have an improved value. Bondholders and the Indenture Trustees must fight such attempts by the Debtor to unfairly treat Public Debt.

F. <u>City of Promise Actions.</u>

The City of Promise passes new legislation to aid All-American in financing additional pollution control improvements required by State and Federal law since the closing of Project 2. The City's Industrial Development Board considered termination of the Lease of Projects 1 and 2 in the Bankruptcy Court and the filing of the Proof of Claim for the Lease indebtedness.

G. <u>Indenture Trustee Actions.</u>

The Indenture Trustee on Project 2 Bonds is also a bank creditor of All-American. Both Indenture Trustees give Notices of Default but do not accelerate. At first the Creditors Committee refuses to allow the Indenture Trustees to be <u>ex officio</u> members of the Creditors Committee but later given the threat of the formation of a separate Bondholder Committee, the Indenture Trustees are allowed to join as <u>ex officio</u> members. As the time for the Plan of Reorganization approaches, the Indenture Trustee for Project 2 resigns. The Debtor and the Indenture Trustees consider: (a) what information should be

given to the Bondholders of the present status of the Bonds and All-American; (b) what plan does All-American have for Projects 1 and 2; (c) what terms for payment will be made in any Plan of Reorganization; and (d) what terms of payment are acceptable to the Bondholders.

H. Subordinated Debentures.

All-American has issued $100,000,000 of Subordinated Debentures. The Indenture for the Subordinated Debentures specifically provides that the Debentures are subordinated in right to receive payment from All-American to the rights of Senior Indebtedness, which is defined as money borrowed obligations or lease obligations. The Subordinated Debenture Indenture was drafted at the same time as the Project 2 Bonds were issued and clearly had the IRB Indebtedness in mind as Senior Debt. Banks agree they are the only ones entitled to the benefits of Subordination. Trade claim they are part of Senior Indebtedness.

I. Security Fraud Action and Indemnity.

All-American and several Key Officers and Directors have been sued by its Stockholders for violation of the Federal Securities Fraud Laws. The Company by a pre-petition Resolution has Indemnified Officers and Directors for their attorney's fees and expenses and liabilities arising out of the securities litigation. The Security Fraud litigation has been stayed as against All-American under S362 but the class Action plaintiffs have filed a claim for $100,000,000 in Bankruptcy. The officers and Directors of All-American apply to the Bankruptcy Court for Indemnity payment arising from the securities litigation or to those that have not been stayed. Trade, Banks and Public Debt finally find something to agree on and all object to Indemnity payments.

J. Preference.

Within 90 days prior to Bankruptcy,the Debtor, All-American, made the following payments

1.	Payment to Project 1 IRB Bondholders a scheduled interest payment.	$1,000,000
2.	Payment to Subordinated Debentures a scheduled interest payment.	$10,000,000
3.	Payment to Trade Creditor	$3,000,000
		$14,000,000

The Debtor seeks repayment of all preferences.

K. Plan of Reorganization.

1. Projected Revenues And Value of Assets.

The Company assets consist of the following:

Cash and Investments (including Preferences returned)	$100,000,000
Plant and Equipment excluding IRB Projects and Depreciation (Book Value)	$250,000,000
Inventory (Raw and Work in Process,) (Book Value)	$100,000,000
Accounts Receivable	$20,000,000
IRB Project 1 (Book Value)	$5,000,000
IRB Project 2 (Book Value)	$15,000,000
	$490,000,000

The Company projects for the next 5 years that revenues net of operating expenses (not including Debt service on Pre-Petition Debt) will be no greater than $40,000,000 and may be as low as $25,000,000.

2. Classification of Claim.

There is no Secured claim except for the IRB Project Indebtedness. The Company for Purposes of the Plan states that the IRB projects be Valued as follows: Project 1 at $25,000,000 and Project 2 at $50,000,000. The IRB Bondholders question such valuation. The Debtor will sell the Projects if a buyer can be found. Otherwise the Debtor will provide for Payment under the Plan. The Debtor splits the creditors into 4 classes:

	Allowed Claim Amount
Class 1	
Administrative Priority Claim	$20,000,000
Class 2	
Secured Claims	
2A. Project 1	$25,000,000
2B. Project 2	$50,000,000
Class 3	
Unsecured Creditors (not Subordinated)	
3A. Bank	$100,000,000
3B. Trade	$100,000,000
3C. Project 2 (Remainder)	$27,500,000
Class 4	
Subordinated Debentures	$100,000,000
Class 5	
Class Action Plaintiffs and Equity holders	$100,000,000
	$522,500,000

3. Plan of Reorganization

Cash required at Confirmation	Claim	Plan Treatment
$20,000,000	(a) Class 1	Administrative Claim to be Paid off in full in cash at confirmation.
$6,000,000	(b) Class 2A	Payment in full of Past due interest (Pre and Post Petition) on Project 1

			IRB due January 1, 1984 and July 1, 1984 of $2,000,000 and July 1 sinking fund of $4,000,000 and either assume the obligation or sell the facility and use proceeds to pay off IRB Project 1 debt.
-0-	(c)	Class 2B	No post petition interest since not fully secured [Section 506(b)] and only claim as Secured $50,000,000 with no cash distribution. Payment 10% interest over original term (8 years) level amortization.
$36,000,000	(d)	Class 3A	20% cash on claim ($20,000,000) plus 80% (100/125) of Subordinated cash distribution (20% of $100,000,000) or $26,000,000 and note for balance at 10% interest (cash) plus 4% interest payable in stock, the 10 year Note to bear interest only for 10 years. Bullet principal payment.
$20,000,000	(e)	Class 3B	20% cash ($20,000,000) distribution and Note for balance at 10% interest (cash) and 4% interest payable in stock. The 10 year Note to bear interest only for 10 years. Bullet principal payment.

$9,000,000	(f)	Class 3C	20% cash ($5,000,000) plus 20% of subordinate cash distribution (20% of $20,000,000) or ($4,000,000) balance note with tax exempt interest at 10% cash interest payment, $2,500,000 of cash to be used to pay pre-petition interest. The 8 year Note to bear interest only for 8 years. Bullet principal payment.
	(g)	Class 4	Note at 8% interest for 20 years bullit payment at end for full amount subordinated debt; the note is to be subordinated to class 3 claims.
________	(h)	Class 5	nothing

Total 91,000,000

Discussion Questions:

1. Does the automatic stay prevent the Indenture Trustee or the Bondholders for Project 1 and Project 2 from accelerating the amounts due under the respective Indentures?

2. Can the Indenture Trustees for the Projects or the Holders of those Bonds successfully request the Court to have All-American pay use and occupancy during the pendency of the Chapter 11 proceedings?

3. What effect, if any, does the lack of the guarantee by All-American of the Bonds have on the obligation of All-American to pay the amount due and owing under the Lease?

4. Do the recent Bankruptcy Amendments affect the determination that the leases used in connection with Project 1 and 2 are not non-residential real estate leases subject to 502(b)(6) of the Bankruptcy Code?

5. If All-American does not assume or reject the leases within sixty days of the institution of the Bankruptcy case, can the

Indenture Trustees for Project 1 and 2 contend with regard to Projects 1 and 2 that All-American must surrender the property to them under recent changes to Section 365 of the Bankruptcy Code?

6. What is the inter-relationship between the claims of All-American and possible counterclaims against All-American with regard to power and labor contracts?

7. Has All-American breached its obligations due to the Project 1 and Project 2 Bondholders by use of other facilities and closing Project 2 to detriment of the Bondholders?

8. Can the lease obligations of All-American under the Project 1 and Project 2 leases be valued not as principal and interest due on the respective Bonds, but as present value of the lease obligations?

9. What effect does the new legislation passed by the City of Promise have on the ability of All-American and its Plan of Reorganization?

10. What role should the City of Promise Industrial Development Board play in All-American's bankruptcy proceeding and is it required to file a proof of claim for the lease indebtedness on Project 1 and Project 2?

11. Could the Indenture Trustees or the Bondholders for Project 1 and Project 2 consider the formation of a Bondholder Committee separate and distinct from the Official Unsecured Creditors' Committee?

12. What is the obligation of All-American to provide the Project 1 and Project 2 Bondholders with relevant information concerning the value of the respective facilities, interested purchasers and financial ability of All-American to reopen Project 2?

13. Can the Bank successfully contend that the Project 1 and Project 2 Bondholders should not receive the benefits of the subordinated debenture issue?

14. What is the effect of a non-consentual plan of reorganization on the rights of the subordinated debentureholders and their ability to receive a distribution under a plan of reorganization?

15. Are the indemnity claims of officers and directors of All-American for attorneys' fees and expenses and liabilities arising out of security fraud litigation subject to a claim of subordination under Section 510(c) of the Bankruptcy Code?

16. Is the payment of $1,000,000 to the Project 1 Bondholders on their fully secured claim a preference since it was made within ninety days prior to the filing of Chapter 11 proceeding?

17. Are the payments to Subordinated Debentureholders and to trade creditors preferences, and how should they be treated with regard to the plan of reorganization?

18. Should the book value of Project 1 be used as the value of the secured claim of the Project 1 Bondholders?

19. Should the book value of Project 2 be used as the value of the secured claim of the Project 2 Bondholders?

20. Can the Debtor propose a feasible plan of reorganization with the $40,000,000 projected net cash flow excluding debt service on pre-petition debt and can greater payment in cash be made to Project 1 and Project 2 Bondholders?

21. Given the assets of All-American and the pre-petition debt of All-American, is All-American actually insolvent?

22. Does the Plan of Reorganization improperly discriminate against the Project 1 and Project 2 Bondholders given the valuation of the secured claim for Project 1 and Project 2?

23. What method of valuation of Project 1 and Project 2 should be used (going concern, cost of replacement, book value or liquidation)?

24. Does All American improperly discriminate against the Project 2 Bondholders by not paying the same percentage in cash to the Project 2 Bondholders on their secured and unsecured claims as is received by other unsecured debt?

25. Does All American in its Plan of Reorganization give the proper benefit of subordination to Project 2 debt since it only gave Project 2 Bondholders a share of the subordinated debt distribution based upon the unsecured portion of the Project 2 Bondholder claim?

26. If the Plan improperly discriminates against Project 2 Bondholders, what actions should the Indenture Trustee and Bondholders take?

27. Should the Indenture Trustees for Project 1 or Project 2 move to lift the automatic stay and foreclose on Project 1 or Project 2 mortages? What factors should the Indenture Trustee consider?

28. Would acceleration of Project 1 or Project 2 indebtedness help in formulating a Plan of Reorganization or preserving the tax exempt status?

NOTES

Program Schedule and Faculty

Fourth Annual Institute on Municipal Finance Law

New York City, September 12-13, 1985

Program Schedule:

First Day: 9:00 a.m.-5:15 p.m.
Morning Session: 9:00 a.m.-12:30 p.m.

Constitutional and statutory principles
Public purpose and loan of credit revisited: *Common Cause* v. *State of Maine; Hawaii Housing Authority* v. *Midkiff*

Scope of municipal antitrust immunity: *Haille* v. *City of Eau Claire*

Tenth Amendment after *Garcia* v. *San Antonio Metropolitan Transit Authority; South Carolina* v. *Regan*

Statutory Authority: *Chemical Bank* v. *PUD No. 1 of Benton County*

Washington Public Power Supply System litigation

Federal tax law
Analysis of tax considerations of creative financing techniques, including issues raised by "puts" and letters of credit

Effect of the 1984 Tax Reform Act and Technical Corrections Act of 1985, including concerns and unsuspected applications of the new arbitrage rebate, federal guarantee and private loan bond provisions

Afternoon Session: 2:00 p.m.-5:15 p.m.

Federal securities law

Registration of separate securities, including "puts" and letters of credit issued by non-exempt issuers

Recent developments in disclosure requirements under Section 10(b) and Rule 10b-5

Rules of Municipal Securities Rulemaking Board

Taxable municipal securities

Emerging issues affecting liability of issuers and counsel in offerings of municipal securities

SEC proposals to require (i) registration of IDBs and (ii) disclosure documents in connection with the issuance of municipal securities generally

Role of counsel in the disclosure process

Analysis of disclosure and reasonable investigation requirements in connection with issuance of municipal securities

Parties involved in the disclosure process, including bond counsel, underwriters, underwriters' counsel, and other counsel and their respective roles

Standards for counsel's conduct in disclosure process

Recent State of Washington legislation which impacts on standards of bond counsel and underwriters' counsel

Second Day 9:00 a.m.-5:15 p.m.
Morning Session: 9:00 a.m.-12:30 p.m.

Emerging financing techniques: views of underwriters and counsel
Letter of credit secured financings

Tax-exempt commercial paper

Tender option bonds, including auction bonds, flexipoints, and daily tenders

Variable rate bonds

Interest rate swaps

Dangers of excess creativity

Afternoon Session: 2:00 p.m.-5:15 p.m.

Bankruptcy Code
Emerging issues in municipal defaults and bankruptcy — probability and effect

Case study of an actual municipal bankruptcy, including analysis of current problems, possible solutions through structure of transaction and format

Need for amendments to Chapter 9 of Bankruptcy Code

Question and answer period

Faculty:

Chairman:
Robert S. Amdursky
Willkie Farr & Gallagher
New York City

Stephen L. Dinces
Cleary, Gottlieb, Steen & Hamilton
New York City

Clayton P. Gillette
Professor
Boston University School of Law
Boston

Michael A. Gort
Senior Vice President
Shearson Lehman Brothers Inc.
New York City

Henry S. Klaiman
Brown, Wood, Ivey, Mitchell
& Petty
New York City

David G. Ormsby
Cravath, Swaine & Moore
New York City

James E. Spiotto
Chapman and Cutler
Chicago

PLI Program Attorney:
Elise Anne Geltzer